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ACCOUNTING TREATMENT OF THE INVESTMENT TAX CREDIT AND ACCELERATED DEPRECIATION FOR PUBLIC UTILITY RATEMAKING PURPOSES

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 1524

TO AMEND SECTIONS 46(F) and 167(L) OF THE INTERNAL REVENUE CODE OF 1954 WITH RESPECT TO THE TREATMENT OF PUBLIC UTILITY PROPERTY

H.R. 6503

TO AMEND THE INTERNAL REVENUE CODE OF 1954 WITH RESPECT TO THE LIMITATIONS ON THE FLOW-THROUGH OF THE INVESTMENT TAX CREDIT IN THE CASE OF CERTAIN REGULATED COMPANIES

JUNE 21, 1982

Serial 97-70

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ACCOUNTING TREATMENT OF THE INVESTMENT TAX CREDIT AND ACCELERATED DEPRECIATION FOR PUBLIC UTILITY RATEMAKING PURPOSES

MONDAY, JUNE 21, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman) presiding.

[Press releases announcing the hearing follow:]

[Press release of May 24, 1982]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A 1 DAY HEARING ON H.R. 1524, RELATING TO THE ACCOUNTING TREATMENT OF THE INVESTMENT TAX CREDIT AND ACCELERATED DEPRECIATION FOR PUBLIC UTILITY RATEMAKING PURPOSES

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee on Ways and Means will conduct a one-day public hearing on Monday, June 21, 1982, beginning at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building. The hearing will be held on H.R. 1524 (Mr. Matsui and Mr. Rousselot), relating to the accounting treatment of the investment tax credit and accelerated depreciation for public utility ratemaking purposes. Under present law, the tax benefits from the investment credit and accelerated depreciation on public utility property generally cannot be passed through to consumers immediately in lower utility rates but must be "normalized" for ratemaking purposes and passed through over the useful life of the relevant public utility property.

H.R. 1524 would amend the Internal Revenue Code to make these accounting rules for utility ratemaking purposes more specific. The bill also would exempt utilities from the present requirement that the investment tax credit and accelerated depreciation be normalized with respect to accounting periods that ended prior to March 1, 1980, if the public utility used accounting methods prescribed by order of a State or local government, public service or utility commission.

This hearing is the result of a request made by Mr. Matsui and Mr. Rousselot and will afford the Committee the opportunity to review the action taken on this matter during the 96th Congress. Similar legislation (H.R. 6806) was reported by the Committee on Ways and Means on July 30, 1980, and passed by the House of Representatives on September 24, 1980.

The Committee will receive testimony from Administration officials to be followed by testimony from Members of Congress and the general public who have requested to be heard.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentation will be limited

with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Committee members to interrogate witnesses. The witnesses will be grouped as panels to expedite the hearing, and strict time limitations will be established for each panelist.

The following is an outline of the procedure to be followed by organizations and individuals who either may want to appear and testify during this hearing or file a written statement for the printed record of the proceedings. All requests should contain the following information:

1. The name of the witness, his title, address, firm affiliation and/or organization he will represent (as well as a telephone number where he or his designated representative may be reached).

2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.

3. A topical outline or summary of comments and recommendations.

Requests to be heard must be made by telephone to Harriett Lawler [telephone (202) 225-3627] by the close of business, Wednesday, June 16, 1982. The telephone request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

Witnesses are required to submit 125 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearances. Failure to comply with this rule may result in the witness not being allowed to testify.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be received by the close of business, Friday, June 25, 1982. These statements should contain the information listed in #1-3 earlier in this press release. The statements should be delivered to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office during the course of the hearing.

[Press Release of June 2, 1982]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, ANNOUNCES INCLUSION OF H.R. 6503 IN THE JUNE 21, 1982, HEARING ON H.R. 1524, RELATING TO THE ACCOUNTING TREATMENT OF THE INVESTMENT TAX CREDIT AND ACCELERATED DEPRECIATION FOR PUBLIC UTILITY RATEMAKING PURPOSES

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the June 21, 1982, public hearing on H.R. 1524 (Mr. Matsui and Mr. Rousselot) relating to the accounting treatment of the investment tax credit and accelerated depreciation for public utility ratemaking purposes will also include H.R. 6503, introduced on May 27, 1982, by the Honorable Fortney H. (Pete) Stark (D., Calif.).

H.R. 6503 would amend the Internal Revenue Code with respect to the present limitations on the flow-through of the investment tax credit in the case of regulated public utilities. The bill would permit public utility regulatory commissions to account for the tax benefits from the investment credit in a manner more consistent with the principles of cost-of-service ratemaking and normalization accounting procedures. Specifically, the bill will amend Code section 46(f) to make the normalization of the investment tax credit similar to the normalization rules of accelerated depreciation under Code section 167(l). The bill also includes a provision, similar to a provision in H.R. 1524, which would exempt utilities from the present requirement that the investment tax credit and accelerated depreciation be normalized with respect to accounting periods that ended prior to March 1, 1980, if the public utilities used accounting methods prescribed by order of a public service or utility commission of a State or local government.

As stated earlier in press release No. 35, requests to be heard must be made by telephone to Harriett Lawler [telephone (202) 225-3627] by the close of business, Wednesday, June 16, 1982. The telephone request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building,

Washington, D.C. 20515. (See Committee press release No. 35 for the announcement of the June 21, 1982, hearing and a description of H.R. 1524.)

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be received by the close of business, Friday, June 25, 1982.

Chairman ROSTENKOWSKI. The committee will come to order.

This morning, the committee will consider two bills relating to the accounting treatment of the investment tax credit and accelerated depreciation for public utility ratemaking purposes.

H.R. 1524 would amend the "normalization" rules of the Internal Revenue Code to make them more specific. The bill would also exempt public utilities from the normalization rules for periods before March 1, 1980 if the public utility used accounting methods prescribed by order of a State or local government, or utility commission. This provision of the bill is designed to deal with a problem that developed in California. Legislation similar to H.R. 1524 was reported by the Committee on Ways and Means and passed by the House in 1980, but did not pass the Senate.

The committee will also consider H.R. 6503 which would make the normalization rules for the investment tax credit similar to the normalization rules for accelerated depreciation.

Our first witness this morning is David Glickman, the Deputy Assistant Secretary of the Treasury for Tax Policy.

STATEMENT OF DAVID GLICKMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. GLICKMAN. Thank you, Mr. Chairman. I am pleased to appear before you today to present the views of the Treasury Department on H.R. 1524 and H.R. 6503, both of which relate to the requirement that the tax benefits of the investment tax credit and accelerated depreciation be "normalized" for purposes of establishing the allowable service charges of regulated public utilities.

As background, Mr. Chairman, regulated public utilities, including telephone and electric companies, generally are allowed the investment tax credit and accelerated depreciation (or, for property placed in service after 1980, the benefits of the accelerated cost recovery system) only if these tax benefits are normalized. Although these normalization rules are exceedingly complex, their purpose is simple: to ensure that these tax benefits are treated as incentives to investment for the benefit of customers over the life of newly acquired plant and equipment rather than as subsidies granted to current utility customers.

Until recently, the regulatory authorities in the State of California have, for ratemaking purposes, accounted for the investment tax credit and accelerated depreciation in a manner that we believe violates the normalization requirements. Absent legislative relief, three companies operating in California will be subject to the severe sanctions that the Internal Revenue Code imposes for failing to satisfy the normalization requirements: they will lose the investment credit and will be required to use straight-line depreciation for certain prior taxable years.

Sections 1 and 2 of H.R. 1524 would amend the Internal Revenue Code to provide explicitly that certain accounting methods used in past years by the California Public Utility Commission do not satis-

fy the normalization requirements. The Treasury Department believes that these accounting methods do not satisfy the existing requirements. Since sections 1 and 2 would merely codify our interpretation of existing law, the Treasury Department has no objection to their enactment.

Section 3 of the bill would provide that violations of the normalization requirements would not cause a taxpayer to lose the benefits of the investment tax credit and accelerated depreciation if certain conditions are satisfied. This provision is designed to eliminate the substantial potential tax liability of several California utilities that were subject to rate orders that did not comply with the normalization requirement.

The Treasury Department takes no position on section 3 of the bill. We recognize that the collection of these tax liabilities would penalize taxpayers who took all feasible steps to comply with the normalization requirements. Nevertheless, we are concerned that its enactment may encourage regulatory commissions to establish ratemaking procedures that would violate the normalization requirements and frustrate congressional intent in enacting these provisions.

Our concern is heightened by the problems that may arise following the enactment of the comprehensive normalization requirements in the Economic Recovery Tax Act (ERTA). These provisions, which the administration supported, require all regulated public utilities to comply with the normalization requirements contained in the act.

Prior to 1981, many utilities were subject to "grandfather" rules and were therefore not subject to the normalization requirements in the code. Most other utility companies were subject to less comprehensive normalization requirements, which allowed a portion of the tax benefits of accelerated depreciation to be passed through to the utility's current customers. As a result of ERTA, all utilities will be required to normalize fully the tax benefits of the investment tax credit and the accelerated cost recovery system. We understand that several regulatory commissions are under pressure from consumers to resist raising utility rates, which is the practical effect of their complying with these new normalization requirements.

In considering this bill, any concerns raised by other public utilities, who will be most immediately affected by actions of the regulatory commissions, should be carefully considered.

Although this section of the bill would eliminate substantial potential tax liabilities, the revenue from the collection of these tax liabilities was not included in our estimates of the fiscal year 1983 budget. In addition, while we believe that the rate orders of the California Public Utility Commission violated the normalization requirements, we anticipate that any asserted tax liabilities would be challenged by the affected taxpayers in court. It is unlikely that additional taxes would be collected for at least several additional years. Accordingly, enactment of this bill would affect our revenue estimates only to the extent that it will require a refund of taxes already paid.

H.R. 6503 contains two provisions. First, the bill would change the normalization requirements in effect for the investment tax

credit. Second, the bill would treat certain past rate orders issued by the California Public Utility Commission as being in compliance with the normalization requirements.

Under present law, a regulated utility will be in compliance with the normalization requirements applicable to the investment tax credit if it complies with either the rate base reduction or the ratable flow-through rules, which are contained in section 46(f) of the code. These rules require regulatory commissions to set rates at levels in excess of the levels that would be set if the investment tax credit were treated as a zero-cost capital subsidy supplied by the Government.

Section 1 of H.R. 6503 would amend section 46(f) to provide that the normalization requirements would be satisfied if the benefits of the investment tax credit are flowed through to consumers no faster than would occur if the utility company's rate base were reduced by the amount of the credit and if a pro rata portion of the credit is flowed through to consumers annually over the life of the applicable asset.

We recognize that there is disagreement concerning the proper method of normalizing the investment tax credit. Nevertheless, in light of Congress decision to retain the existing normalization rules in 1981, we do not believe that it is timely to reconsider this question in the narrow context of this bill.

Section 2 of the bill would provide that certain past rate orders would be deemed to be in compliance with the normalization requirements. This section of H.R. 6503 is intended to provide relief to the same regulated utilities as would benefit from section 3 of H.R. 1524, and our comments on that provision of H.R. 1524 are equally applicable here. We note, however, that H.R. 6503 fails to specify that the particular method previously used by the California Public Utility Commission violates the normalization requirements.

Unless the bill is revised to remove any doubt that this accounting method violates the normalization requirements, the enactment of section 2 of H.R. 6503 could be interpreted as an indication that the California method complies with the normalization rules. Since this method frustrates the purpose of the normalization rules, we believe that Congress should eliminate any doubt on this question if it decides to grant retroactive relief.

For the reasons stated above, the Treasury Department does not take a position on the grant of relief from the sanctions of the normalization requirements that would be provided to the California utilities by H.R. 1524 and H.R. 6503. We are concerned, however, that this relief may reduce the intended deterrent effect of the normalization requirements. Congress should consider this problem carefully before enacting this legislation.

That is the conclusion of my remarks, Mr. Chairman. I will be happy to try to answer any questions you might have.

Chairman ROSTENKOWSKI. Thank you, Mr. Glickman.

Mr. Conable will inquire.

Mr. CONABLE. We don't sense a clarion call here, Mr. Glickman, about what we ought to do. Clearly, we have a problem of serious loss to the company unless this relief is granted. We are, as you know, upset about ratemaking agencies, in effect, destroying

incentives for capital investment that we try to give to various business enterprises including utilities. And we would like to find some way of avoiding this, because we know as sure as the ratemaking agencies can get away with flow through that utilities will be back in here looking for further tax advantages to try to offset the effect of the violation of the normalization process. What do you suggest? How do we handle this point?

Mr. GLICKMAN. Mr. Conable, the way you phrase it is exactly the questions we have been struggling with since we were asked to comment on this legislation. Obviously, we are sympathetic with the problem that the California utilities in question have. In many respects they have gone as far, they did everything they possibly could to try to avoid the problem. Obviously it was the ratemaking body in California that has caused the problem.

The problem obviously that we have is that if we open the door here, especially in view of the problems that we understand are going on right now in the country with other ratemaking bodies and the pressure that is being brought to bear on them not to raise rates, we are concerned that in the very near future the normalization rules are going to be consistently violated. Each time it happens the utilities are going to be coming in here requesting this same type of relief.

If you look at it from that standpoint, it seems to me that this body can expect again in the near future to be hearing from some other utility. I guess one of the questions that would have to be answered here is how much concern some of the other utilities around the country have, that if we take this position with California, what is going to happen in the future with respect to their ratemaking authorities, also. If they are concerned that this will set a precedent, I think that this is something this committee has to be concerned about, also.

Mr. CONABLE. One thing we want to avoid is having the California situation repeated in other States. You say this may create that precedent. That it is not in the interests of the consuming public, it is not in the interests of the tax—the stability of the Tax Code or anything else.

But you say Congress should consider what it does very carefully. We need some help on that, sir. As you know, we are not the experts. You folks in Treasury are suppose to be the experts. So I just wonder what you would suggest.

I am not trying to put you on the spot, but you are putting us on the spot. Something has got to be done, obviously. One way or another we are going to have to resolve this issue.

Mr. GLICKMAN. Mr. Conable, you know, I appreciate the problem. Like I said, we are sympathetic with the problem in California. I think that if this committee and Congress decided to grant this relief, the Treasury Department and the administration would be hard-pressed to object to that decision.

Mr. CONABLE. Yes, I see. I think we would like to work with you to avoid creating any unfortunate precedent. So I hope we will have your further advice as we go down the line. I guess that is all I can say. We are concerned about this and have been in the past. It is obviously an issue that isn't going to go away and we ought to

try to find some way of resolving it so we won't create a proliferation, the very thing that you are most concerned about.

Chairman ROSTENKOWSKI. Mr. Glickman, in your statement, you indicate that the Treasury Department has no objection to sections 1 and 2 of H.R. 1524 since these sections would merely codify the interpretation of present law. However, is it your judgment that these sections are necessary?

Mr. GLICKMAN. Mr. Chairman, I think that there obviously are questions out there, whenever we have to give rulings that say that we think something is not normalization, there are questions out there. I think that whenever those type of questions arise, if we can set a bright line rule, I think that is the best way to go. We feel that the position taken in the bill in sections 1 and 2 is correct, and it represents Treasury's position. Thus, we think we would not discourage, and possibly would encourage, the inclusion of those provisions in the legislation to make it clear that our interpretation is the correct interpretation.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman. I would like to thank you for holding hearings on H.R. 1524. It is most appreciated.

Mr. Glickman, to follow up the chairman's questions, it appears to me that you are saying, rather than just not having objections to sections 1 and 2 of H.R. 1524, you actually would like us to adopt the language in those sections?

Mr. GLICKMAN. Mr. Matsui, we think that is what the law is right now.

Mr. MATSUI. Of course, that still has to be resolved by litigation. In fact, in the litigation with the utilities in California, you could lose. You are not guaranteeing the Government a victory in 1987 or 1988 or whenever this matter finally reaches the Supreme Court, are you?

Mr. GLICKMAN. No, sir; you are correct in that. All I am really saying is that we feel that is the position. What we really think the legislation does is codify what the law states right now. In that regard, I think you would possibly, in any future litigations——

Mr. MATSUI. Let me ask, if you are a practicing attorney with one of the utilities such as Pacific Bell or General Telephone, could you make a legitimate and reasonable argument at trial in support of their right to a refund?

Mr. GLICKMAN. I assume that an argument can be made. I think that it is——

Mr. MATSUI. You are not saying that Pacific Bell and GTE would be paying lawyers to make specious arguments? Don't you think their arguments are being reasonably made?

Mr. GLICKMAN. I think there are arguments that can be made; yes, sir.

Mr. MATSUI. Given this possibility, would you like to resolve the matter legislatively? I would have to believe that the conclusion would be that you would favor the adoption of sections 1 and 2.

Mr. GLICKMAN. Mr. Matsui, we would favor sections 1 and 2.

Mr. MATSUI. In other words, you are not just neutral on its adoption, you want us to adopt it to help resolve any future problems that may arise with the utilities and the Internal Revenue Service?

Mr. GLICKMAN. The only impression I don't want to leave here is that the answer we have given to this point represents any question as to the status of the law today. I wouldn't want to lead you to believe that we had questions about that in our minds right now. I think that from a litigation standpoint, obviously, if you can say that this is the interpretation that Congress intended, all that does is going to make sure that future litigation probably will not arise over it.

All I am saying is I don't feel that there is any need for us to compromise our position as to what the correct interpretation of the law is right now.

Mr. MATSUI. Perhaps we should have gotten the consent from AT&T and GTE that they would not use your statements in any future court action. Maybe you then could have been more candid with us. Let me say this—and I think I have already made this point—you cannot at this time guarantee that the Federal Government will prevail in its litigation with Pacific Bell and GTE. Is that correct?

Mr. GLICKMAN. I think that whenever you are dealing with litigation, Mr. Matsui, as you know, you can never give those types of guarantees.

Mr. MATSUI. In light of this potential ambiguity in the law defining normalization, do you believe it equitable that Pacific Bell, GTE, and Southern Gas should be given some relief regarding the conflict into which they have been placed? Using the AAA accounting method as they were required was not necessarily unreasonable, was it?

Mr. GLICKMAN. There are many cases, Mr. Matsui, that go into the courthouse all the time when people could contend that the law is not actually clear when the Internal Revenue Service wins the case, the Government wins the case. You could always argue under those types of situations, well, that the law is not clear. Thus, there ought to be some sort of relief given in these types of situations.

In my judgment, the relief that should be given here should not be given based upon the interpretation of the law. If there is going to be relief given, it should be based on the fact the companies did all that they could do, as I understand it, to solve the problem. And it was the regulatory authorities which refused to accept the normalization rules, as I think the interpretation is probably the correct interpretation.

Mr. MATSUI. It is my understanding that PUC, in the development of the standard they used for depreciation, believed it was complying with the laws. That is my understanding.

Mr. GLICKMAN. I don't know the answer to that. I think it was clear from the outset, when the ruling issues came up, that this was not normalization as intended by Congress when passed.

Mr. MATSUI. That is the IRS interpretation.

Mr. GLICKMAN. That is correct.

Mr. MATSUI. The potential revenue loss of the bill—the only potential revenue loss associated with this bill which can clearly be stated at this time—is the amount of refund that the utilities would be refunded if this bill is passed. Is this correct?

Mr. GLICKMAN. That is correct as of right now.

Mr. MATSUI. Right; because you may lose the lawsuit in 1987 or 1988 or 1990, whenever it is finally terminated. Is that right?

Mr. GLICKMAN. If the litigation was ultimately lost, there would be no additional revenue lost.

Mr. MATSUI. In the event the legislation is passed, the IRS would save a considerable amount of money in legal fees it would otherwise have to spend in pursuing the lawsuit. Is that correct?

Mr. GLICKMAN. Obviously there would be a savings in legal fees. If you looked at it on the basis of how much you would gain compared to the legal fees involved, I think if you win, the potential liability of the companies is much greater obviously than the legal fees.

Mr. MATSUI. Obviously. What is the revenue impact of H.R. 6503? Do you happen to know what that is? It is my understanding that there is some uncertainty as to the amount, therefore you may not be able to state it, and it was not able to be stated by the Joint Committee.

Mr. GLICKMAN. Mr. Matsui, I do not have—excuse me. It is our feeling that it should have no revenue impact. As I understand, the companies feel that the rates are going to go down, but our analysis of it indicates that it should not have a revenue impact.

Mr. MATSUI. I have no further questions. Thank you.

Chairman ROSTENKOWSKI. Mr. Gradison will inquire.

Mr. GRADISON. Mr. Glickman, if we were to pass the first of these bills, what effect, if any, do you think it would have, for example, in California, in influencing future decisions by their ratemaking authority? Restating this, do you think that the passage of this bill will in any way cause the Public Utility Commission in California to come up with different approaches in the future than it has in the past?

Mr. GLICKMAN. I think it clearly could have that effect, since the change would make it absolutely clear that the approaches that have been used in the past were not workable, I think that the ratemaking authorities could come up with additional, different approaches, which again might not be normalization under the definition in the law. But, and obviously, Mr. Gradison, that is the problem we are concerned about.

Mr. GRADISON. In what manner can we make sure that State commissions permit normalization? Must we do it through some means other than the tax laws? Would we have authority, for example, to do this, perhaps not through this committee but through the Commerce Committee?

Mr. GLICKMAN. We have discussed in our office whether there could be some alternative approaches to try to solve the problem. Mr. Gradison, we have not come up with one. One possibility which I guess possibly might be considered somewhat draconian is to say Congress is not going to solve the problem. Obviously, that would be a clear message to the ratemaking bodies, that if they do not satisfy the normalization rules, that at some point in time they are going to have to give increases in rates to make up for the losses that result from the fact that the investment tax credit and the accelerated depreciation are not available.

Now again, that is a rather strong approach to the problem. But it seems to me that would send out a real message. Whether that is warranted at this point, I am not sure.

Mr. GRADISON. Wouldn't we send out a real message if we leave the law just the way it is? That is to say, if there were indeed these enormous tax liabilities levied on the companies, wouldn't that be a jolt also to the regulatory authorities which would have to concern themselves with some alternative means of restoring the financial capabilities of these companies to serve the public?

Mr. GLICKMAN. I guess that is what I meant, Mr. Gradison, when I said that perhaps Congress should not pass legislation which cleanses the past years with respect to these utilities. That means it is back in the courthouses and the cases will be argued. If they are ultimately lost by the taxpayer and won by the government, there will be a substantial additional revenue impact on the companies which obviously have to be passed through to the users of it in an increase in ratemaking.

Mr. GRADISON. Thank you, Mr. Chairman. Thank you, Mr. Glickman.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman. I am sorry, Mr. Glickman, I didn't get your comments on the retroactivity of H.R. 1524. Do you have a comment on that?

Mr. GLICKMAN. You are talking about cleansing, in essence, the three utilities that are having the problems in California right now, Mr. Stark?

Mr. STARK. Yes.

Mr. GLICKMAN. Yes. The Treasury took no position on this issue. Our problems were twofold. One, I think we appreciated the problems of the utilities, empathized with them, realized that they had gone a long way to trying to solve the problem. And the regulatory authority had taken its position despite that.

On the other hand, the problem that concerns us is the fact that normalization is an important concept. Its integrity should be maintained. We become concerned that if the rate-setting bodies around the country, come up with approaches which do not satisfy normalization, that again we will be sitting here at some point in the future with those same utilities making the arguments that we tried our best and the ratemaking authorities forced a flow-through method of accounting on us. Thus, they would like to be cleansed.

If that happened, it seems to me the whole purpose of the investment tax credit and accelerated depreciation as directed toward the public utilities would go for naught because we would not be giving the capital formation additional acquisition power for new equipment that the provisions were put in the law to accomplish.

Mr. STARK. Do you think utilities make their investment decisions based on tax consequences, or based on demand for their services?

Mr. GLICKMAN. Obviously the demand for the services are significant. I think in most cases they look at the cost of capital. In determining the cost of capital I think that the tax consequences play a substantial role. Thus, I would have to say that that does come into play in a real effect, especially when we are talking about——

Mr. STARK. What are their alternatives? They don't have an alternative. They have to provide the service when the customer demand is there regardless of what the taxes are. What possible sense would it make for a utility to double its generating capacity, for instance, if it didn't have the customers? Just to get a 10-percent investment tax credit?

Mr. GLICKMAN. Well, I think that the question really might come down to one as to whether they continue to use the facilities they have in place right now, or whether they determine that it is in their best interest, and ultimately in the best interest of their customers to go out and make new investments. I think this would be the type of thinking that goes through their minds.

Mr. STARK. You changed your position, I think, since the last time. You previously supported what, in effect, is 6503. At this point I gather you are taking no position.

Mr. GLICKMAN. As I remember, Mr. Stark, in an institutional sense, Treasury did not have an objection the last time. I think that the concerns that are present today may have been accentuated to some degree by the passage of ERTA and we are now hearing that there is greater pressure today on the ratesetting bodies not to raise rates and again we become concerned with the integrity of the normalization procedure.

Mr. STARK. Mr. Matsui's bill, as I understand it, in effect, suggests that we forgive about $1,800 million in taxes. Is there any way that could be collected over time without being passed through to the ratepayers?

Mr. GLICKMAN. Mr. Stark, I am not totally familiar with how the ratemaking goes on although I would have to say that it seems to me that if the utilities were forced to pay this additional amount, utlimately it would find its way through to the users, to its customers just as most additional expenses find their way through.

Mr. STARK. But not all tax credits find their way through to the ratepayers, do they?

There are opportunities whereby utilities can take advantage of tax credits or rapid recovery and not pass it through to the ratepayers; isn't that correct?

Mr. GLICKMAN. Of course, that is the whole concept of normalization.

Mr. STARK. Precisely. So on the one hand you are saying that if they have to pay extra taxes they stick it to the ratepayers but if we give other taxpayers' money to shareholders of the utility it doesn't get passed back to the ratepayers in all cases, correct?

That is what you just said and that is exactly what I am trying to determine here. I am perfectly willing to let the utilities charge the ratepayers for extra taxes if they made a mistake or got caught in a regulatory bind but then I don't know why when we give them extra credits they shouldn't have to pass all the credits back through to the ratepayers instead of having a choice.

Mr. GLICKMAN. Let me say this: It seems to me that one of the concepts of the normalization rules is that passthrough is ultimately going to take place.

But the question is do you pass it through to the benefit of the present customers or do you pass it through to the benefit of all

the customers that are really going to be paying for it over a period of time?

Without normalization you are passing it through primarily to the customers in existence during the early stages.

Going the other direction, in response to your question, assuming the cases are won by the Internal Revenue Service at a subsequent point in time, it seems to me that what you have done is benefited the early customers to the detriment of those customers at a later point in time because what you have done is forced them to pay the entire amount rather than spreading it evenly.

Again, the whole question here, it seems to us, is just one of trying to make sure that we keep the normalization rules in place as they were intended and not encourage the ratemakers around this country to start violating the normalization rules.

However we can accomplish that we would be satisfied. These are the problems that you all should be wrestling with.

Mr. STARK. Don't you think as a matter of principle retroactive tax laws either way are a bad policy?

Mr. GLICKMAN. As a general proposition we would not support retroactive treatment, that is correct.

Mr. STARK. One final question, is it correct that if you eliminate the communications utilities that all the utilities in the United States probably pay not more than $500 or $600 million in total income tax, is that about a ball park figure?

Mr. GLICKMAN. I simply don't know the answer to that question.

Mr. STARK. Does anybody with you know?

Mr. GLICKMAN. No, sir; we don't have it. I would be happy to supply it for the record.

Mr. STARK. Assuming that that is correct and I would suspect that for the last 2 years that was the figure, would it make any difference to the Treasury if we eliminated the corporate income tax for regulated utilities and went to a consumption tax which would amount to, I think the last time we calculated this, something like less than half a percent? Currently a quarter of 1 percent of the utility bills would get us as much revenue as all of the taxes paid by all of the noncommunications utilities in the country.

Mr. GLICKMAN. Mr. Stark, that is obviously a very broad ranging question. A lot of people would think that you might want to go to a consumption tax rather than what we have anyway. I always have questions where we pick out one segment of the economy and treat them differently than everyone else irrespective of the unique nature of them.

Chairman ROSTENKOWSKI. Mr. Rousselot will inquire.

Mr. ROUSSELOT. Mr. Glickman, last year's Economic Recovery Tax Act requires all regulated utilities to use normalization methods.

Now, doesn't this action make it almost imperative that normalization requirement be clarified and reinforced?

Mr. GLICKMAN. I would think that it is important that the normalization provisions be as clear as possible, yes.

Mr. ROUSSELOT. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Are there any further questions?

Mr. MATSUI. Mr. Glickman, I just want to solicit some further clarification. I know that in these times it is easy to take potshots

at utilities because the rates are high for instance, I think you recognized this point in your opening statement did you not?

Mr. GLICKMAN. Yes, sir; I did.

Mr. MATSUI. The entire issue of normalization and its possible interpretation by other PUC's is why you believe that the Congress should deal with sections 1 and 2; is that correct?

Mr. GLICKMAN. Yes, sir.

Mr. MATSUI. And in addition to that, the entire issue of whether you normalize or whether you flow through in your accounting methods is really not a question of whether the stockholders get more money or whether the utilities keep more money or the ratepayers save money. It is a question of which generation of ratepayers actually will be paying for the cost of energy; is that correct?

Mr. GLICKMAN. Yes, sir.

Mr. MATSUI. And that is the bottom line, either the present generation of those ratepayers if you use the accelerated method or the future generation if you use flow-through.

Mr. GLICKMAN. That is right, and it is a question of whether you are going to come up with something that applies it across the board or whether you are going to benefit the users in existence at the time the new acquisition takes place to the detriment of the users at the end and, obviously, it also goes, in our minds at least, to the question of capital formation.

Mr. MATSUI. I would like to just follow up on Mr. Rousselot's comment in terms of ERTA and the accelerated depreciation given to the utilities last year, if I may.

I agree with you, the utilities, if, they need additional energy resources, have to come up with new capital formation capabilities, I guess the issue is whether they go out on the bond market at 17 or 18 percent or maybe not even be able to float the bonds or alternatively have additional capital made available through the accelerated depreciation benefits provided by ERTA.

Is that the fundamental theory of what we did last year?

Mr. GLICKMAN. I think that is correct. We want to reduce the cost of capital and one of the ways of doing that is through allowing the acceleration of the deductions, right.

Mr. MATSUI. And that is why you favored the accelerated depreciation provisions as they pertained to utilities last year?

Mr. GLICKMAN. Just in general, yes, as it applies to all capital intensive industries.

Mr. MATSUI. Because it was your feeling that using the accelerated depreciation method and allowing normalization, you are actually going to have lesser costs to the ratepayer in the long run than if you have to obtain capital on the bond market giving existing interest rates?

Mr. GLICKMAN. Probably lesser costs, certainly a more even spreading of the cost.

Mr. MATSUI. From your perspective a more equitable distribution of the costs.

Mr. GLICKMAN. Yes, sir.

Mr. MATSUI. Thank you.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

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Mr. STARK. Following along on that, Mr. Glickman, it seems to me there is a third alternative that did not come up in your recent exchange. If you could purchase a capital investment at a high interest cost, and you could purchase it with other taxpayers' money would this not be a higher cost to the economy and result in a widening of the deficit?

Mr. GLICKMAN. Yes, sir.

Mr. STARK. Or is there not a third alternative which might let the stockholders share in some of the fortune of high interest rates and issue some more common stock albeit at a very low price, but is that not a third method for raising capital and would that not impact solely on the shareholders and not necessarily on the ratepayers or the economy in general?

Mr. CONABLE. Would the gentleman yield?

Mr. STARK. Surely.

Mr. CONABLE. Ultimately they are going to decide whether they issue new stock or whether they borrow money on what the cost is.

Mr. STARK. If I may reclaim my time, it is simple mathematics. I am sure the gentlemen understands if the ratemaking bodies are allowing them 10 percent on their equity and the market for capital markets is 17 percent, it is much nicer to get it from the taxpayers than to have the shareholders only get a 10 percent return for their money.

Mr. GLICKMAN. Well, but again, if you have people that are going to make stock acquisitions, make their investments through the stock approach, I think that it is correct to say that when they make their determination of how they are going to make their investment they will realize that they go out and buy bonds that are generating 17 percent they have got to get a similar type of return on their investment.

Mr. STARK. It is the old stockholder and the new stockholder. The old stock will be diluted and the new stock will earn the return the market demands. So you are making the stockholders pay the penalty of past actions.

The present stock will be less in value. It will be diluted to get the rate up high enough on the new stock issued and, therefore, you are directing the penalty, as it were, not to the taxpayers or the ratepayers but at the old shareholders.

Mr. GLICKMAN. Mr. Stark, it seems to me ultimately that the users are the ones that are going to have to pay the fee and whoever makes the investment in the company is going to have to get a return on investment commensurate with what is going in the marketplace at that point in time.

Mr. STARK. But it costs somebody something. I am just saying that the stockholders were the only ones whom you did not suggest could participate and they do have a chance to participate by foregoing short-term profits, really. That is what they are doing.

And I just think that we all too often forget that maybe they ought to pony up a little as well.

Chairman ROSTENKOWSKI. Are there any further questions of Mr. Glickman?

[No response.]

Chairman ROSTENKOWSKI. Thank you very much, Mr. Glickman.

The Chair calls Mr. Donald Kiefer. Welcome to the committee, Mr. Kiefer. It is a pleasure to have you with us. I want to thank you personally for all the services you have rendered to this committee. No one presents analysis better than you, and we appreciate that. If you want to identify yourself for the record, you may proceed with your testimony. We are ready to receive it.

STATEMENT OF DONALD W. KIEFER, SPECIALIST IN PUBLIC FINANCE AND FINANCIAL INSTITUTIONS, ECONOMICS DIVISION, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Mr. KIEFER. Thank you, Mr. Chairman.

My name is Donald Kiefer, a specialist in public finance and financial institutions in the Economics Division of the Congressional Research Service of the Library of Congress.

I would like to thank you for the invitation to appear before you today to discuss the required ratemaking treatment of the investment tax credit in the public utility industry, as specified in section 46(f) of the Internal Revenue Code, and the changes which would be made by H.R. 6503, introduced by Representative Stark.

This is a subject on which I have done research for the past several years; my most recent article on the subject, published in the October 1981 Journal of Business, provides the analytical basis for many of my conclusions and is appended to my statement.

I will be skipping over certain portions of my statement in the interest of time. I would request that the entire statement appear in the record.

The investment tax credit reduces by 10 percent the cost of acquiring qualifying capital assets; that is, it is a subsidy which takes the form of an effective price reduction on equipment investment. A price reduction on capital assets has two effects on a firm:

First, it decreases the amount of financial capital required by the firm and therefore the necessary amount of return to capital and; second, it reduces the subsequent amount of annual depreciation.

In competitive industries market forces operate to provide investors the market rate of return on their invested capital, so these effects of a reduction in the cost of capital assets would be reflected in reduced product prices.

One of the purposes of regulation is to permit natural monopolies to earn a normal rate of return, but to prevent them from earning an excess rate of return, on their invested capital. Thus, it is relevant to consider whether the results of the regulatory process emulate the economic effects achieved in competitive industries.

The present Tax Code rules on the ratemaking treatment of the investment tax credit in the public utility industry do not permit attainment of a result which parallels that in competitive industries, because the two effects of a reduction is the cost of capital assets enumerated in the previous paragraph cannot both be achieved.

Present law permits the recognition of one or the other of the economic effects of the investment tax credit on a regulated company, but not both effects.

The treatment specified in Internal Revenue Code section 46(f)(1) recognizes the lower amount of the accumulated deferred investment tax credit (ADITC) from the rate base, but disallows a reduction of annual depreciation charges to reflect the lower cost capital assets.

The treatment specified in code section 46(f)(2) allows an annual reduction in cost of service charges—the reduction is in the form of a ratable flow-through of the tax credit, but accomplishes the same thing as if depreciation charges were reduced to reflect the lower cost assets—but it forbids any reduction in the rate base to recognize the lower amount of invested capital and required return to capital.

This second ratemaking treatment, which has been chosen by most public utility companies because it is the most favorable for firms with long-lived equipment, in essence requires the utility regulators to permit utility shareholders to earn a rate return on financial capital which they have not provided but which has been provided cost-free by the Federal Government through the investment credit.

Therefore, neither of the forms of normalization of the investment credit permitted by the Tax Code is consistent with the effects of the credit in a competitive industry.

To be consistent with these effects would require both exclusion of the ADITC from the rate base and adjustment of annual depreciation charges to reflect the lower cost assets, a treatment which I have termed "economic normalization."

The equivalent of these adjustments would be made in public utility ratemaking if the 10-percent reduction in equipment cost were achieved through a reduction in equipment price rather than through use of the investment tax credit. Economic normalization of the investment credit is the approach which is embodied in the first section of H.R. 6503.

The differences between the ratemaking treatment currently specified in section 46(f) and economic normalization of the ITC have consequences for utility customers, the utilities themselves, and tax collections by the U.S. Treasury. The potential magnitude of these effects is not insigificant.

The aggregate amount of deferred tax credits in the electric and telephone utility industries in 1980 was $13.7 billion, and had been growing at an annual rate of nearly $2 billion over the previous 5 years.

Deferred tax credits are not separated from deferred taxes attributable to accelerated depreciation in published data for the gas utility industry; but I estimate deferred tax credits in this industry in 1980 to have been approximately $1.3 billion.

If these accumulated deferred investment tax credits would have been excluded from the rate base in calculating utility revenue requirements—which is the change that would occur in switching from the ratemaking treatment under section 46(f)(2) to economic normalization—electric utility rates charged to customers would have been lower by about $1.1 billion, telephone rates lower by about $1 billion, and gas rates by about $195 million in 1980.

In percentage terms these amounts imply that if economic normalization had been fully applicable to all deferred investment tax

credits in 1980, electric utility rates would have been lower by about 1.3 percent, telephone rates by 1.8 percent, and gas rates by 0.4 percent.

These changes would have resulted in decreases in utility company cash flow and profits of approximately $710 million in the electric utilitis, $660 million in the telephone companies, and $130 million in the gas utilities in 1980, and would have also reduced Federal tax collections by about $1.5 billion.

These figures indicate magnitudes of the potential effects if H.R. 6503 were adopted and once economic normalization became fully applicable to all deferred investment tax credits in the utility industry.

In reality, of course, since H.R. 6503 would apply only to new utility investment beginning the year after enactment, the effects of the bill would be very small at the outset and would build gradually as new vintages of utility assets came under economic normalization .

For example, I estimate that in the first year in which the legislation were effective, aggregate utility rates in the country would decrease by about $375 million, or less than 0.2 percent, and total cash flow to the utilities and Federal tax revenues would decrease by about $250 million.

On past occasions when this committee or its subcommittees have considered economic normalization of the investment tax credit, a number of issues have been raised by various testifiers.

First, it has been maintained that the argument that economic normalization is the appropriate ratemaking treatment to emulate the effects of the investment credit in the unregulated sector of the economy is based on a theoretical model which assumes pure competition.

The argument does assume the economy to operate competitively, at least in the long run. The competitive model is the basis of most general policy analysis because it is the commonly held view of how we would like our economy to perform, and also because it is still believed to be more characteristic of the U.S. economy than a model which assumes substantial constraints, rigidities, and imperfections.

One can turn the issue around, however, and ask, "What economic assumptions would be necessary to lead to the conclusion that the ratemaking treatment of the investment credit specified in section 46(f)(2) would be appropriate to parallel the effects of the ITC in the unregulated sector of the economy?"

The assumptions are two: First, that the investment credit is completely unsuccessful in stimulating any additional investment in the unregulated industries; and second, that regulatory agencies are totally unresponsive to changing rates of return in the unregulated sector of the economy in determining allowed rates of return for regulated firms.

The first assumption is necessary because the expansion of investment in response to an investment subsidy drives down the marginal rate of return on new investment from its higher level immediately after the subsidy is initiated.

The second assumption is necessary because the goal of the regulatory process is to provide a rate of return to regulated industries which will be competitive in the private capital markets.

If regulatory commissions increase allowed rates of return in the utility industry in response to higher rates of return in unregulated industries, and this is essentialy the way the process works, then the ITC would not create a permanent differential between rates of return in the regulated and unregulated industries even if the first assumption were true.

Thus, unless both of these assumptions are true—and I do not believe that they are—then the ratemaking treatment of the investment tax credit specified in section 46(f)(2) is more generous to utilities than is appropriate to parallel the economic effects of the credit in the unregulated sector of the economy.

It has been alleged that the present ratemaking treatment is consistent with the goals of Congress in adopting the investment tax credit.

Congress specified three goals in adopting the credit: First, to reduce the effective cost of acquiring new equipment; second, to increase the profitability of new investment and; third, that the financial assistance provided by the credit should itself be used for new investment.

The higher investment profitability was intended to raise the prospective rate of return above the cost of capital, thereby inducing additional investment.

As alluded to above, once the additional investment stimulated by the credit had occurred, one would again expect the marginal rate of return on investment to equal the marginal cost of capital.

Hence, the higher rate of return on new investment is a temporary phenomenon during the transition to a higher level of investment.

However, the reduced investment costs and cash flow effects of the investment credit would remain. These results would be achieved in the public utility industry by economic normalization of the investment credit.

It has been observed that in adopting the present ratemaking requirements Congress intended to institute a sharing of the benefits of the investment credit between utility shareholders and customers. But both the present treatment and economic normalization involve a sharing of the benefits.

Sharing versus not sharing is not the issue, but in what proportions the benefits shall be shared.

The only ratemaking treatment which can be characterized accurately as providing all the benefits to utility customers and no benefits to the utilities is flow-through treatment, which is no longer permitted on new equipment as a result of provisions adopted in the Economic Recovery Tax Act of 1981.

In a related argument, it has been claimed that the utility companies would receive no benefit from the investment credit under economic normalization because this treatment does not require regulatory authorities to allow the utilities a higher rate of return.

But economic normalization of the investment credit would exactly parallel the ratemaking treatment of accelerated depreciation, which is consistent with its economic effects. Accelerated de-

preciation amounts to an interest-free loan to the benefiting company.

Economic normalization of the interest-free loan requires treating the loan as cost-free capital in the ratemaking process, a treatment which does not increase the allowed rate of return of the utility company.

This is the ratemaking treatment which is permitted by sections 167(1) and 168(e)(3) of the tax code and is used in most regulatory jurisdictions.

Thus, the accumulated deferred income taxes attributable to accelerated depreciation, which amounted to $14.1 billion in the electric utilities and $14.5 billion in the telephone utilities in 1980, and thus are over twice as large as deferred ITC's, are currently excluded from the rate base in determining utility revenues.

Unless the utilities are willing to claim that they would not object to giving up accelerated depreciation because they do not receive any benefit from it under present ratemaking rules, it is inconsistent for them to claim that they would receive no benefit from the investment credit with economic normalization.

Economic normalization would permit the ITC also to be treated as cost-free capital to the utility and, therefore, would not require regulatory commissions to provide utilities with higher rates of return, but it would provide the utilities with higher cash flow, a reduced need to rely on the private capital market for investment capital, and reduced prices for their services, which would result in higher demand for their services.

In other words, the benefits the utilities would receive from the investment credit coupled with economic normalization are precisely the same as they would receive from a 10-percent reduction in the price of their capital equipment.

In summary, it seems to me that after separating fact from fiction there are principally two advantages and two disadvantages associated with a change from current Tax Code requirements for the ratemaking treatment of the investment tax credit to economic normalization.

The first advantage is that the Tax-Code-required distortion in the ratemaking process which results in treating the investment credit differently in the regulated industries than in competitive industries, and requires utility regulators to provide a higher rate of return than they deem appropriate, would be eliminated.

The second advantage is that utility rates charged to customers would be reduced.

The first disadvantage is that utility companies would have reduced cash flow and profits at a time when at least some of these companies are experiencing well publicized financial strains.

On the other hand, the public utilities are among the largest beneficiaries of the accelerated cost recovery system in the Economic Recovery Tax Act of 1981, so now may be a propitious time to make the change in ratemaking treatment if it is ever going to be made.

The second disadvantage is that the policy change would result in a decline in Federal tax collections at a time when Congress is attempting to raise revenues to offset a substantial budget deficit.

All of these effects—the reductions in utility rates, utility company cash flow, and Federal revenues—would be very small at the outset and build gradually as new vintages of utility assets came under economic normalization.

Thank you, Mr. Chairman. I would be happy to respond to any questions.

[The prepared statement and attachment follow:]

STATEMENT OF DR. DONALD W. KIEFER

SUMMARY

The present tax code rules on the ratemaking treatment of the investment tax credit do not permit attainment of a result which parallels the effects of the credit in competitive industries or is consistent with treating the investment credit as cost-free capital. Such a result would require "economic normalization" of the investment credit, the approach embodied in H.R. 6503.

If economic normalization of the investment credit had been in effect and fully applicable to all deferred investment tax credits in 1980:

Electric utility rates charged to customers would have been lower by about $1.1 billion, telephone rates lower by about $1.0 billion, and gas utility rates would have been lower by about $195 million.

Utility company cash flow and profits would have been lower by approximately $710 million in the electric utility industry, $660 million in the telephone industry, and $130 million in the gas utilities.

Federal tax collections from the utility industry would have been lower by about $1.5 billion.

In reality, of course, since H.R. 6503 would apply only to new utility investment beginning the year after enactment, the effects of the bill would be very small at the outset and build gradually as new vintages of utility assets came under economic normalization.

The argument for economic normalization assumes the economy to operate competitively, at least in the long run. To argue that the present code requirements for ratemaking treatment of the ITC parallel the effects in the unregulated sector of the economy requires assuming: (1) that the investment credit is completely unsuccessful in stimulating any additional investment in the unregulated industries, and (2) that regulatory agencies are totally unresponsive to changing rates of return in the unregulated sector of the economy in determining allowed rates of return for regulated firms.

Economic normalization is consistent with the goals of Congress in adopting the investment tax credit.

Both the present ratemaking treatment and economic normalization involve a sharing (but in different proportions) of the benefits of the investment tax credit between the utility's shareholders and customers.

Economic normalization of the investment credit would exactly parallel the ratemaking treatment of accelerated depreciation permitted by the tax code, which is consistent with its economic effects.

The primary advantages and disadvantages associated with a switch to economic normalization of the investment tax credit are:

Advantages.—The tax-code-required distortion in the ratemaking process which results in treating the investment credit differently in the regulated industries than in competitive industries would be eliminated.

Utility rates charged to customers would be reduced.

Disadvantages.—Utilities would experience decreases in cash flow and profit at a time when at least some of these companies are experiencing financial strains.

Federal tax collections would decline at a time when Congress is attempting to raise revenues to offset a substantial budget deficit.

STATEMENT

Mr. Chairman and members of the committee, I am Donald W. Kiefer, a specialist in public finance and financial institutions in the Economics Division of the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss the required ratemaking treatment of the investment tax credit in the public utility industry, as specified in section 46(f) of the internal revenue code, and the changes which would be made by

H.R. 6503, introduced by Representatives Stark. This is a subject on which I have done research for the past several years:[1] my most recent articles on the subject, published in the October 1981 Journal of Business, provides the analytical basis for many of my conclusions and is appended to my statement.

The investment tax credit reduces by 10 percent the cost of acquiring qualifying capital assets; that is, it is a subsidy which takes the form of an effective price reduction on equipment investment. A price reduction on capital assets has two effects on a firm: (1) it decreases the amount of financial capital required by the firm and therefore the necessary amount of return to capital, and (2) it reduces the subsequent amount of annual depreciation. In competitive industries market forces operate to provide investors the market rate of return on their invested capital, so these effects of a reduction in the cost of capital assets would be reflected in reduced product prices. One of the purposes of regulation is to permit natural monopolies to earn a normal rate of return, but to prevent them from earning an excess rate of return, on their invested capital. Thus, it is relevant to consider whether the results of the regulatory process emulate the economic effects achieved in competitive industries.

The present tax code rules on the ratemaking treatment of the investment tax credit in the public utility industry do not permit attainment of a result which parallels that in competitive industries, because the two effects of a reduction in the cost of capital assets enumerated in the previous paragraph cannot both be achieved. Present law permits the recognition of one or the other of the economic effects of the investment tax credit on a regulated company, but not both effects. The treatment specified in internal revenue code section 46(f)(1) recognizes the lower amount of invested capital and required return to capital through the exclusion of the accumulated deferred investment tax credit (ADITC) from the rate base, but disallows a reduction of annual depreciation charges to reflect the lower cost capital assets. The treatment specified in code section 46(f)(2) allows an annual reduction in cost of service charges (the reduction is in the form of a ratable flow-through of the tax credit, but accomplishes the same thing as if depreciation charges were reduced to reflect the lower cost assets), but if forbids any reduction in the rate base to recognize the lower amount of invested capital and required return to capital. This second ratemaking treatment, which has been chosen by most public utility companies because it is the most favorable for firms with long-lived equipment, in essence requires the utility regulators to permit utility shareholders to earn a rate return on financial capital which they have not provided but which has been provided cost-free by the Federal government through the investment credit. The tax code, thus, builds a federally mandated distortion into the ratemaking process in the sense that regulatory agencies are required by the tax code to provide a higher rate of return than they deem appropriate on private capital invested in utility companies.

Therefore, neither of the forms of normalization of the investment credit permitted by the tax code is consistent with the effects of the credit in a competitive industry. To be consistent with these effects would require both exclusion of the ADITC from the rate base and adjustment of annual depreciation charges to reflect the lower-cost assets, a treatment which I have termed "economic normalization." The equivalent of these adjustments would be made in public utility ratemaking if the 10-percent reduction in equipment cost were achieved through a reduction in equipment price rather than through use of the investment tax credit. Economic normalization of the investment credit is the approach which is embodied in the first section of H.R. 6503.

The differences between the ratemaking treatment currently specified in section 46(f) and economic normalization of the ITC have consequences for utility customers, the utilities themselves, and tax collections by the U.S. Treasury. The potential magnitude of these effects is not insignificant. Table 1 reports the amount of accumulated deferred investment tax credits in the major electric and telephone utilities for 1975 through 1980, the most recent year for which data are published. The aggregate amount of deferred tax credits in these two industries in 1980 was $13.7 billion, and had been growing at an annual rate of nearly $2 billion over the previous five years. Deferred tax credits are not separated from deferred taxes attributable to accelerated depreciation in published data for the gas utility industry; but I estimated deferred tax credits in this industry in 1980 to have approximately $1.3 billion. If these accumulated deferred investment tax credits would have been excluded from

[1] For a recent example see: U.S. Library of Congress. Congressional Research Service. The Impact of the Economic Recovery Tax Act of 1981 on the Public Utility Industry by Donald W. Kiefer. Washington, 1982. (Report No. 82-6E).

the rate base in calculating utility revenue requirements (which is the change that would occur in switching from the ratemaking treatment under section 46(f)(2) to economic normalization), electric utility rates charged to customers would have been lower by about $1.1 billion, telephone rates lower by about $1.0 billion, and gas rates by about $195 million in 1980. In percentage terms these amounts imply that if economic normalization had been fully applicable to all deferred investment tax credits in 1980, electric utility rates would have been lower by about 1.3 percent, telephone rates by 1.8 percent, and gas rates by 0.4 percent. These changes would have resulted in decreases in utility company cash flow and profits of approximately $710 million in the electric utilities, $660 million in the telephone companies, and $130 million in the gas utilities in 1980, and would have reduced Federal tax collections by about $1.5 billion.[2]

TABLE 1.—ACCUMULATED DEFERRED INVESTMENT TAX CREDITS IN THE ELECTRIC AND TELEPHONE UTILITY INDUSTRIES

[In thousand dollars]

Year	Electric utilities [1]	Telephone utilities [2]
1975	$1,732,770	$2,188,921
1976	2,831,357	2,966,269
1977	4,074,634	3,820,433
1978	5,244,971	4,605,004
1979	6,318,370	5,549,083
1980	7,093,958	6,591,677

Sources:
[1] Energy Information Administration, U.S. Department of Energy, Statistics of Privately Owned Electric Utilities in the United States, 1980 Annual, Classes A and B Companies, Table 21, p. 29.
[2] Federal Communications Commission, Statistics of Communications Common Carriers, Years 1975–1980, Table 16.

These figures indicate magnitudes or the potential effects if H.R. 6503 were adopted and once economic normalization became fully applicable to all deferred investment tax credits in the utility industry. In reality, of course, since H.R. 6503 would apply only to new utility investment beginning the year after enactment, the effects of the bill would be very small at the outset and would build gradually as new vintages of utility assets came under economic normalization. For example, I estimate that in the first year in which the legislation were effective, aggregate utility rates in the country would decrease by about $375 million, or less than 0.2 percent, and total cash flow to the utilities and Federal tax revenues would decrease by about $250 million.

On past occasions when this committee or its subcommittees have considered economic normalization of the investment tax credit, a number of issues have been raised by various testifiers. To provide additional clarification of the debate, I would like to address some of these issues. First, it has been maintained that the argument that economic normalization is the appropriate ratemaking treatment to emulate the effects of the investment credit in the unregulated sector of the economy is based on a theoretical model which assumes pure competition. The argument does assume the economy to operate competitively, at least in the long run. The competitive model is the basis of most general policy analysis because it is the commonly held view of how we would like our economy to perform, and also because it is still believed to be more characteristic of the U.S. economy than a model which assumes substantial constraints, rigidities, and imperfections. The policies which have been adopted by Congress during the past year and a half to stimulate saving, investment, and capital formation assume that the forces of competition are still strong in the U.S. economy. One can turn the issue around, however, and ask, "What econom-

[2] All of these estimates assume the average allowed rate of return on rate base to have been 10 percent in 1980. While allowed rates of return vary substantially from one ratemaking decision to another, depending on the circumstances of the case, 10 percent appears to be a reasonable approximation for the average in 1980. See National Association of Regulatory Utility Commissioners, 1980 Annual Report on Utility and Carrier Regulation pp. 295–340, 482. The estimates also assume that economic normalization would be fully implemented by regulatory agencies and that the effects of the change in ratemaking treatment would not be offset by an increase in allowed rate of return. To the extent that the rates of return permitted by regulatory agencies were increased to maintain the earnings of the utilities, the estimates above would be decreased.

ic assumptions would be necessary to lead to the conclusion that the ratemaking treatment of the investment credit specified in section 46(f)(2) would be appropriate to parallel the effects of the ITC in the unregulated sector of the economy?" The assumptions are two: (1) that the investment credit is completely unsuccessful in stimulating any additional investment in the unregulated industries, and (2) that regulatory agencies are totally unresponsive to changing rates of return in the unregulated sector of the economy in determining allowed rates of return for regulated firms. The first assumption is necessary because the expansion of investment in response to an investment subsidy drives down the marginal rate of return on new investment from its higher level immediately after the subsidy is initiated. Thus, if the investment credit is successful in stimulating expanded investment, the marginal rate of return on investment will not remain at the higher level created by the subsidy, but will decrease toward the pre-subsidy level. The second assumption is necessary because the goal of the regulatory process is to provide a rate of return to regulated industries which will be competitive in the private capital markets. If regulatory commissions increase allowed rates of return in the utility industry in response to higher rates of return in unregulated industries, then the ITC would not create a permanent differential between rates of return in the regulated and unregulated industries even if the first assumption were true. Thus, unless both of these assumptions are true—and I do not believe that they are—then the ratemaking treatment of the investment tax credit specified in section 46(f)(2) is more generous to utilities than is appropriate to parallel the economic effects of the credit in the unregulated sector of the economy.

It has been alleged that the present ratemaking treatment is consistent with the goals of Congress in adopting the investment tax credit. Congress specified three goals in adopting the credit: (1) to reduce the effective cost of acquiring new equipment, (2) to increase the profitability of new investment, and (3) that the financial assistance provided by the credit should itself be used for new investment.[3] The higher investment profitability was intended to raise the prospective rate of return above the cost of capital, thereby inducing additional investment. As alluded to above, once the additional investment stimulated by the credit had occurred, one would again expect the marginal rate of return on investment to equal the marginal cost of capital. Hence, the higher rate of return on new investment is a temporary phenomenon during the transition to a higher level of investment. However, the reduced investment costs and cash flow effects of the investment credit would remain. These results would be achieved in the public utility industry by economic normalization of the investment credit. The present ratemaking treatment, which grants utility companies a permanently higher rate of return, parallels a phenomenon in the unregulated sector which is only transitory and is eliminated by the induced increase in investment and changes in capital costs.

It has been observed that in adopting the present ratemaking requirements Congress intended to institute a sharing of the benefits of the investment credit between utility shareholders and customers. But both the present treatment and economic normalization involve a sharing of the benefits. Sharing versus not sharing is not the issue, but in what proportions the benefits shall be shared. The only ratemaking treatment which can be characterized accurately as providing all the benefits to utility customers and no benefits to the utilities is flow-through treatment, which is no longer permitted on new equipment as a result of provisions adopted in the Economic Recovery Tax Act of 1981 (there is a transition period in the Act between the date of enactment and January 1, 1983). The article appended to my statement was written, in part, in response to an earlier article which had argued that flow through was the only proper treatment of the investment credit because the methods of normalizing the credit currently permitted by the tax code provide too much of the benefit to the utilities. One of the purposes of my article was to point out that economic normalization can provide appropriate rate reductions to customers while at the same time providing the benefits that Congress intended to utilities.

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[3] Revenue Act of 1962, Report of the Committee on Ways and Means to accompany H.R. 10650, 87th Congress, 2d Session, March 16, 1962, p. 8.

"The investment credit will stimulate investment because—as a direct offset against the tax otherwise payable—it will reduce the cost of acquiring depreciable assets. This reduced cost will stimulate additional investment since it increases the expected profit from their use. The investment credit will also encourage investment because it increases the funds available for investment. . . . In addition, it is the hope of the committee that the savings from the credit itself also will be used for new investment in further advancing the economy."

In a related argument, it has been claimed that the utility companies would receive no benefit from the investment credit under economic normalization because this treatment does not require regulatory authorities to allow the utilities a higher rate of return. But economic normalization of the investment credit would exactly parallel the ratemaking treatment of accelerated depreciation, which is consistent with its economic effects. Accelerated depreciation amounts to an interest-free loan to the benefiting company. Economic normalization of the interest-free loan requires treating the loan as cost-free capital in the ratemaking process, a treatment which does not increase the allowed rate of return of the utility company. This is the ratemaking treatment which is permitted by sections 167(1) and 168(e)(3) of the tax code and is used in most regulatory jurisdictions. Thus, the accumulated deferred income taxes attributable to accelerated depreciation, which amounted to $14.1 billion in the electric utilities and $14.5 billion in the telephone utilities in 1980, and thus are far larger than deferred ITCs, are currently excluded from the rate base in determining utility revenues. Unless the utilities are willing to claim that they would not object to giving up accelerated depreciation because they do not receive any benefit from it under present ratemaking rules, it is inconsistent for them to claim that they would receive no benefit from the investment credit with economic normalization. Economic normalization would permit the ITC also to be treated as cost-free capital to the utility and therefore would not require regulatory commissions to provide utilities with higher rates of return, but it would provide the utilities with higher cash flow, a reduced need to rely on the private capital market for investment capital, and reduced prices for their services, which would result in higher demand for their services. In other words, the benefits the utilities would receive from the investment credit coupled with economic normalization are precisely the same as they would receive from a 10-percent reduction in the price of their capital equipment.

In summary, it seems to me that after separating fact from fiction there are principally two advantages and two disadvantages associated with a change from current tax code requirements for the ratemaking treatment of the investment tax credit to economic normalization. The first advantage is that the tax-code-required distortion in the ratemaking process which results in treating the investment credit differently in the regulated industries than in competitive industries, and requires utility regulators to provide a higher rate of return than they deem appropriate, would be eliminated. The second advantage is that utility rates charged to customers would be reduced. The first disadvantage is that utility companies would have reduced cash flow and profits at a time when at least some of these companies are experiencing well publicized financial strains. On the other hand, the public utilities are among the largest beneficiaries of the accelerated cost recovery system in the Economic Recovery Tax Act of 1981, so now may be a propitious time to make the change in rate-making treatment if it is ever going to be made. The second disadvantage is that the policy change would result in a decline in Federal tax collections at a time when Congress is attempting to raise revenues to offset a substantial budget deficit. All of these effects—the reductions in utility rates, utility company cash flow, and Federal revenues—would be very small at the outset and build gradually as new vintages of utility assets came under economic normalization.

Attachment

THE EFFECTS OF ALTERNATIVE REGULATORY TREATMENTS OF THE INVESTMENT TAX CREDIT IN THE PUBLIC UTILITY INDUSTRY

by

Donald W. Kiefer

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The Effects of Alternative Regulatory Treatments of the Investment Tax Credit in the Public Utility Industry

This paper examines the effects of alternative regulatory treatments of the investment tax credit on utility rates, tax payments, cash flow, and rate of return in the public utility industry, both with regard to a single asset and to a growing firm. The paper contends that a type of normalization which is not presently allowed in the U.S. tax code can provide appropriate rate reductions to customers and cash flow benefits to utilities but would avoid providing a rate of return higher than that intended by the regulatory authority.

A recent paper by Thompson and Weygandt (1977) evaluated the alternative regulatory treatments of the investment tax credit (ITC) in the public utility industry and concluded that flow-through treatment "is the only proper method for treatment of the investment credit, given that the investment function should be regulated by the need of the ratepayer and not by providing excessive profits to the utility through the investment tax credit" (p. 509). This article expands the earlier analysis in several directions and draws a different conclusion.

Thompson and Weygandt's analysis was based on a model which compared the aggregate reduction in utility rates and increase in return to stockholders resulting from the alternative rate-making treatments of the ITC over the life of a single utility asset. Rather than using mathematical derivations, as Thompson and Weygandt did, this article employs a simulation model which permits full consideration of how the effects of the regulatory treatments change over time. The simulation analysis focuses on the cash flow and tax payments of the utility

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(the effect on tax payments was the reason given by Congress for requiring normalization treatment) as well as on the utility rates charged to customers and the rate of return earned by stockholders. The analysis of regulatory treatments is expanded to include a possible treatment—herein termed "economic normalization"—which was suggested but not evaluated by Thompson and Weygandt. Finally, the simulation model is used to evaluate the effects of the alternative rate-making treatments of the ITC on a growing utility firm, and it is shown that conclusions drawn from the single-asset case do not extend to analysis of the firm. This article contends that economic normalization is consistent with the logic of the regulatory process, provides appropriate utility rate reductions to customers, and benefits utility companies through higher cash flow while avoiding provision of "excessive profits" to the utility.

I. The Alternative Rate-making Treatments of the Investment Tax Credit

The rules regarding allowable treatment of the investment tax credit in rate making for public utilities by regulatory agencies were enacted in the Revenue Act of 1971. These rules will be exposited through use of a simplified financial model of a regulated firm. The model necessarily portrays a highly abstracted view of the regulatory process. Whereas actual regulatory policy involves an intricate blending of economic, social, political, and environmental objectives through a variety of regulatory instruments, the model characterizes the process as largely mechanistic, involving the application of established rules to determine allowable utility rates. Since the debate over regulatory treatment of the ITC has focused almost exclusively on economic and financial implications, this approach would not seem to impose serious restrictions on the analysis. The model also assumes that the overall rate of return actually attained is always equal to the allowed rate of return; this is the strongest possible version of assuming no regulatory lag.

A. The General Model

The general utility regulatory formula used to determine allowed revenue, and the expressions for taxable income, income tax, cash flow, and book profits for a utility which uses straight line depreciation for both book and tax purposes (assumed to focus the analysis on the ITC) and receives no investment tax credit, can be written as follows:

Case 1

$$R_{tt} = r_{tt} \cdot \left[V_t - \sum_{j=t-n}^{t} Dj \right] + Dt + C_t + T_{tt}, \qquad \text{(1a)}$$

$$y_{1t} = R_{1t} - D_t^s - C_t - i_{1t}, \tag{1b}$$

$$T_{1t} = z \cdot y_{1t}, \tag{1c}$$

$$F_{1t} = y_{1t} - T_{1t} + D_t^s, \tag{1d}$$

$$P_{1t} = y_{1t} - T_{1t}, \tag{1e}$$

$$r_{1t} = u_t \cdot d_t + re_t \cdot (1 - d_t), \tag{1f}$$

$$i_{1t} = u_t \cdot d_t \cdot \left[V_t - \sum_{j=t-n}^{t} D_j^t\right]. \tag{1g}$$

where:

the subscript 1 designates case one with no ITC,
the subscript t designates time,

R = allowed or required revenue,
r = overall allowed rate of return,
re = allowed rate of return on common equity,
V = average gross value of assets,
D^s = annual straight line depreciation,
$\sum_{j=t-n}^{t} D_j^t$ = total amount of straight line depreciation taken through year t on assets included in V_t (n = life of utility's assets),
C = cash operating costs (except interest and income taxes),
y = taxable income,
i = interest expense,
T = Federal income tax,
z = Federal income tax rate (assumed to be a flat rate),
F = cash flow,
P = book profits,
u = interest rate paid on long-term debt,
d = portion of assets financed by long-term debt.

Thus, the allowed revenue, R_{1t}, is equal to: (1) the overall allowed rate of return, r_{1t}, multiplied by the rate base, $[V_t - \Sigma_{j=t-n}^{t} D_j^t]$, which equals the depreciated value of the utility's assets; plus (2) the cost of service, which equals depreciation, D_t^s, plus operating costs, C_t, plus income taxes, T_{1t}. The equations for taxable income and income tax are standard and self-explanatory. The equations for cash flow and book profits are, in fact, derived expressions. They are stated in terms of the tax variables, rather than in their more traditional format, because of the focus of this paper on tax treatment. The interest cost is a function of the embedded cost of long-term debt, u_t, multiplied by the debt ratio, d_t, and the rate base. The overall allowed rate of return is an average of the interest rate paid on long-term debt and the rate of return allowed on equity weighted by their proportions of the capital structure of the utility.

This model, referred to as case 1, is used for comparative purposes

throughout the analysis that follows. Because the equations for alternative regulatory treatments always refer to the situation in a given year, the t subscripts will be dropped for simplicity and merely understood to be present. In this shorthand, $\Sigma_{j=t-n}^{t} Dj$ will be expressed as $\Sigma_j D^s$.

B. Present Rate-making Treatments of the Investment Tax Credit

The three principal regulatory treatments of the investment tax credit specified in the Revenue Act of 1971 are portrayed in the three equation systems displayed below:

Case 2, Flow-Through

$$R_2 = r_1 \cdot \left[V - \sum_j D^s\right] + D^s + C + T_2 \tag{2a}$$

$$y_2 = R_2 - D^s - C - i_1 \tag{2b}$$

$$T_2 = z \cdot y_2 - I^a \tag{2c}$$

$$F_2 = y_2 - T_2 + D^s \tag{2d}$$

$$P_2 = y_2 - T_2 \tag{2e}$$

where: I^a = actual amount of investment tax credit

Case 3, Rate-Base Normalization

$$R_3 = r_m \cdot \left[V - \sum_j D^s - B\right] + D^s + C + T_3 + I^a, \tag{3a}$$

$$y_3 = R_3 - D^s - C - i_m, \tag{3b}$$

$$T_3 = z \cdot y_3 - I^a, \tag{3c}$$

$$F_3 = y_3 - T_3 + D^s, \tag{3d}$$

$$P_3 = y_3 - T_3 - I^a, \tag{3e}$$

$$i_m = u \cdot d \cdot \left[V - \sum_j D^s\right] - u \cdot e \cdot B, \tag{3f}$$

$$r_m = u \cdot \left[\frac{d \cdot \left[V - \sum_j D^s\right] - e \cdot B}{\left[V - \sum_j D^s - B\right]}\right] + re \cdot \left[\frac{(1-d) \cdot \left[V - \sum_j D^s\right] - (1-e) \cdot B}{\left[V - \sum_j D^s - B\right]}\right], \tag{3g}$$

$$B = \sum_t (I^a - I^n), \tag{3h}$$

$$I^n = \sum_j \frac{I^a}{n}, \tag{3i}$$

where:

r_m = overall allowed rate of return under ITC normalization,
B = accumulated deferred investment tax credits,
i_m = interest expense under ITC normalization,
e = portion of B used to replace debt financing,
I^n = normalized amount of investment tax credit.

Case 4, Cost-of-Service Normalization

$$R_4 = r_m \cdot \left[V - \sum_j D^e\right] + D^e + C + T_4 + (I^a - I^n), \tag{4a}$$

$$y_4 = R_4 - D^e - C - i_m, \tag{4b}$$

$$T_4 = z \cdot y_4 - I^a, \tag{4c}$$

$$F_4 = y_4 - T_4 + D^e, \tag{4d}$$

$$P_4 = y_4 - T_4 - (I^a - I^n). \tag{4e}$$

The equations in case 2 represent flow-through regulatory treatment of the ITC, which may be used only with regard to utility property which qualifies for flow-through treatment under the accelerated depreciation rules in the Tax Reform Act of 1969.[1] The equations in this case are similar to case 1, except that the investment tax credit, I^a, is, of course, subtracted from the tax computation. The equations for interest and rate of return are identical and are not repeated. Under flow-through treatment, the amount of actual taxes paid is included as a cost of service in the rate formula; thus, the reduction in taxes due to the ITC directly reduces the utility's required revenues. In fact, the reduction is required revenues, compared to case 1, is greater than the ITC by a factor of $1/1 - z$ due to the simultaneity of required revenues and tax payments.

If utility property does not qualify for flow-through treatment it must receive normalization treatment to be eligible for the ITC. The tax code provides two principal methods of normalizing the investment tax credit. The equations in case 3 represent the "general rule" (option 1) in the tax law, which will be referred to here as the rate-base method (this is Thompson and Weygandt's Option B). Under rate-base normalization the utility makes adjustments to its rate base by subtracting the actual amount of the ITC, I^a, from its rate base and then adding the normalized ITC amount, I^n,[2] back into the rate base annually over the life of the asset. This procedure amounts to subtracting the accumu-

1. Public utility property which qualifies for flow-through treatment of accelerated depreciation is property of the same or similar kind for which the utility used flow-through treatment for assets most recently placed in service in its July 1969 accounting period (see Internal Revenue Code sec. 167[1][2][c]).

2. The normalized investment tax credit is the cumulation of the pro rata shares (based on the utility's asset lives) of the ITC received each year (see eq. [3i]).

lated deferred investment tax credits (ADITC)[3] from the rate base. It yields the same results, so far as the rate base is concerned, as if the original cost of the assets had been reduced by the amount of the ITC. The taxes taken into account in determining the cost of service are the "normalized" taxes, that is, actual taxes paid plus the amount of the ITC. Any reduction in the utility's cost of service due to the ITC is prohibited under rate-base normalization.

The deferred tax credits under normalization serve as zero-cost capital for the utility and substitute for a portion of private capital which otherwise would be required. A different term for interest expense appears in the normalization equations to allow for debt replacement by the ADITC. The overall allowed rate of return may also change under normalization if the ADITC does not substitute proportionately for debt and equity (eq. [3g]).

The equations in case 4 represent the "ratable flow-through" method (option 2), which will be referred to here as cost-of-service normalization (Thompson and Weygandt's Option C). This is the normalization method which apparently has been selected by most firms which normalize the ITC. Under this method the amount of taxes taken into account as a cost of service ignores the actual amount of ITC and is reduced by the normalized ITC. Any reduction in the utility's rate base due to the ITC is prohibited under cost-of-service normalization. As in the previous case, different terms for the rate of return and interest appear in the first two equations to allow for external capital replacement by the ADITC. The equations for i_m, r_m, B, and I^n are the same as for case 3. Thompson and Weygandt drew attention to the fact that the congressional committee reports on the Revenue Act of 1971 called for allowance of the equity rate of return on the ADITC, rather than the overall rate of return, under cost-of-service normalization. However, in the interim the final Treasury regulations on this provision have been adopted, and they permit allowance of the overall rate of return on the ADITC.[4] Equation (4a) is consistent with the regulations.

A third type of normalization treatment is available to a utility only "if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business . . . determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy."[5] This treatment, which will be referred to here as shortage normalization, forbids any adjustment—to either the utility's rate base

3. The accumulated deferred investment tax credit (ADITC) is the cumulated difference between the actual ITC and the normalized ITC (see eq. [3h]).

4. Internal Revenue Service, T.D.7602, Final Regulations on Investment Credits for Public Utility Property, March 20, 1979.

5. Internal Revenue Code, sec. 46(f)(1).

or cost of service—to reflect the ITC (this is Thompson and Weygandt's Option A). The Federal Energy Regulatory Commission has permitted this type of ITC normalization for natural gas pipeline companies since 1972.[6] Equations (5a)–(5e) represent shortage normalization:

$$R_s = r_m \cdot \left[V - \sum_j D^a\right] + D^a + C + T_s + I^a, \tag{5a}$$

$$y_s = R_s - D^a - C - i_m, \tag{5b}$$

$$T_s = z \cdot y_s - I^a \tag{5c}$$

$$F_s = y_s - T_s + D^a, \tag{5d}$$

$$P_s = y_s - T_s - I^a. \tag{5e}$$

Under this treatment the ADITC is not excluded from the rate base and the taxes included as a cost of service are actual taxes paid plus the amount of the investment tax credit.

C. Economic Normalization

Since there are two standard (i.e., nonshortage) methods of normalizing the ITC allowed by the tax code—rate-base normalization and cost-of-service normalization—the question arises as to which form of normalization, if either, is appropriate from an economic perspective. One of the purposes of regulation is to force the regulated industries, to the extent possible given the peculiarities of public utility economics, to emulate the economic results of a competitive industry. To this extent it is relevant to consider the economic effects of the investment tax credit on unregulated industries.

The investment tax credit is a grant received when new capital investment is made which, in effect, reduces the cost of the investment to the recipient company. Thus, the ITC has the same impact on the company (ignoring carry-overs) as if it had received a price reduction on the capital assets it purchases. A price reduction on capital assets will have two effects on a firm: by decreasing the amount of investment capital required by the firm it decreases the necessary amount of return to capital, and it also reduces the subsequent amount of annual depreciation.[7] In a competitive market these influences will be reflected in lower prices for the firm's output, and this is the result which should be emulated in the regulated industries.

However, this competitive result is not permitted by the methods of

6. See Federal Power Commission Order No. 448, 47FPC, 141, January 24, 1972.

7. When the ITC was first adopted in 1962 it included a requirement that the basis of benefiting assets be adjusted downward by the amount of the credit in determining the amount of future tax depreciation. In 1964, to increase the subsidy associated with the ITC, the basis adjustment was repealed.

normalizing the investment tax credit which are presently allowed by the tax code. Present law permits the recognition of one or the other of the economic effects of the investment tax credit on a regulated company, but not both effects. Rate-base normalization (case 3) recognizes the lower amount of invested capital and required return to capital through the exclusion of the ADITC from the rate base but disallows a reduction of annual depreciation charges to reflect the lower-cost capital assets. Cost-of-service normalization (case 4) allows an annual reduction in cost-of-service charges (the reduction is in the form of a ratable flow-through of the reduced tax charge, but accomplishes the same thing as if depreciation charges were reduced to reflect the lower-cost assets), but it forbids any reduction in the rate base to recognize the lower amount of invested capital and required return to capital. Therefore, neither allowed form of normalization of the investment tax credit in the regulated industries is appropriate from an economic perspective. "Economic normalization" of the ITC would require both exclusion of the ADITC from the rate base *and* adjustment of annual depreciation charges to reflect the lower-cost assets. Such a form of normalization of the ITC can be represented in equations as follows:

$$R_e = r_m \cdot \left[V - \sum_j D^s - B\right] + (D^s - I^a) + C + T_e + I^a, \quad (6a)$$

$$y_e = R_e - D^s - C - i_m, \quad (6b)$$

$$T_e = z \cdot y_e - I^a, \quad (6c)$$

$$F_e = y_e - T_e + D^s, \quad (6d)$$

$$P_e = y_e - T_e - (I^a - I^a). \quad (6e)$$

This system of equations is the same as for rate-base normalization (see eqq. [3a]–[ei]) except for the I^a term, subtracted from the depreciation charge in the equation for required revenues, and the I^a term which appears in the equation for book profits as a result. Interestingly, this normalization method was suggested by Thompson and Weygandt but was not included in their analysis. It was also suggested in Kiefer (1979), has been the subject of two sets of hearings before the Ways and Means Committee, and has been endorsed by the Treasury.[8]

II. Simulation Analysis

A. *The Single Asset*

In their book on the effects of accelerated depreciation in the public utility industry, Brigham and Pappas (1970) comment that "the compli-

8. See U.S. Congress 1979, 1980. The Treasury Department testified in favor of economic normalization of the ITC at both hearings.

cated interrelationships among these variables make algebraic analysis virtually impossible, but they do lend themselves to simulation . . . ."[9] The same statement could be made with regard to the investment tax credit. While Thompson and Weygandt's analysis is algebraic, such an analysis of this issue is necessarily limited and may yield misleading conclusions. Hence, this study employs a simulation model, the basic structure of which is provided in the Appendix, to explore the impact of the alternative regulatory treatments of the ITC. Initially, the effects of the credit with regard to a single utility asset (the case studied by Thompson and Weygandt) are evaluated. In the following subsection the financial characteristics of the regulatory treatments in a growing utility firm are assessed.

The asset simulation model assumes the asset is purchased and instantaneously becomes fully operative (and is brought into the rate base) at the beginning of the first year. The entire cost of the asset is assumed to qualify for a 10% investment tax credit. Straight line depreciation and zero salvage value are assumed. For the analysis reported here the simulation parameters are set at values intended to represent the electric utility industry in 1978; therefore, the allowed rate of return on equity = .113, the average interest rate on long-term debt = .0756, and the ratio of debt to total private capitalization = .625 (preferred stock is treated as long-term debt in the derivation of these data).[10] The simulations assume that the cost-free capital from deferred investment tax credits substitutes proportionately for debt and equity financing; a seemingly plausible assumption in view of the stability of the capital structures of the utilities during the period of existence of the tax credit. A 30-year asset life and a 46% tax rate are assumed. The simulations ignore cash operating costs (they are presumably independent of the alternatives being considered) and focus on the capital costs associated with the asset.

The utility revenues over the life of a hypothetical $100 asset under the alternative regulatory treatments of the investment tax credit are shown in table 1 and graphed in figure 1. In the base case, with no investment tax credit, utility revenues are $15.70 in the first year and decrease linearly to $3.54 in the thirtieth year. It is a characteristic of utility regulatory accounting that the allowed revenues with regard to an investment decline over its life as the rate base declines. Under the other five regulatory treatments the asset benefits from a $10 investment tax credit in its first year. In the case of flow-through treatment the impact on utility rates is dramatic. Since $I^a/(1 - z) = \$10/.54 = \$18.52$ is greater than the total allowed revenues in case 1 in the first year, the revenues for flow-through are actually negative; that is, aggregate revenues of the utility firm would be reduced from the level otherwise

9. Brigham and Pappas 1970, p. 5.

10. The data are derived from U.S. Department of Energy (1979), pp. 31, 34.

TABLE 1 Hypothetical Example of Utility Revenues over the Life of an Asset under Alternative Regulatory Treatments of the Investment Tax Credit ($)

Year	Accumulated Deferred Investment Tax Credit (Average), Cases 3, 4, 5, 6	Utility Revenues					
				Normalization			
		Base Case (1)	Flow-Through (2)	Rate-Base (3)	Cost-of-Service (4)	Shortage (5)	Economic (6)
1	4.83	15.70	−2.82	15.09	15.27	15.89	14.47
2	9.50	15.28	15.28	14.08	15.04	15.66	13.47
3	9.17	14.86	14.86	13.71	14.61	15.23	13.09
4	8.83	14.44	14.44	13.33	14.18	14.79	12.71
5	8.50	14.02	14.02	12.95	13.74	14.36	12.33
6	8.17	13.60	13.60	12.57	13.31	13.93	11.96
7	7.83	13.18	13.18	12.20	12.88	13.50	11.58
8	7.50	12.76	12.76	11.82	12.45	13.06	11.20
9	7.17	12.34	12.34	11.44	12.01	12.63	10.83
10	6.83	11.92	11.92	11.07	11.58	12.20	10.45
11	6.50	11.51	11.51	10.69	11.15	11.77	10.07
12	6.17	11.09	11.09	10.31	10.72	11.33	9.69

13	5.83	10.67	10.67	9.93	10.28	10.90	9.32
14	5.50	10.25	10.25	9.56	9.85	10.47	8.94
15	5.17	9.83	9.83	9.18	9.42	10.04	8.56
16	-4.83	9.41	9.41	8.80	8.99	9.60	8.18
17	4.50	8.99	8.99	8.43	8.55	9.17	7.81
18	4.17	8.57	8.57	8.05	8.12	8.74	7.43
19	3.83	8.15	8.15	7.67	7.69	8.31	7.05
20	3.50	7.73	7.73	7.29	7.26	7.87	6.68
21	3.17	7.31	7.31	6.92	6.82	7.44	6.30
22	2.83	6.90	6.90	6.54	6.39	7.0	5.92
23	2.50	6.48	6.48	6.16	5.96	6.58	5.54
24	2.17	6.06	6.06	5.78	5.53	6.14	5.17
25	1.83	5.64	5.64	5.41	5.09	5.71	4.79
26	1.50	5.22	5.22	5.03	4.66	5.28	4.41
27	1.17	4.80	4.80	4.65	4.23	4.85	4.04
28	.83	4.38	4.38	4.28	3.80	4.41	3.66
29	.50	3.96	3.96	3.90	3.36	3.98	3.28
30	.17	3.54	3.54	3.52	2.93	3.55	2.90

NOTE.—Initial value of asset = $100.00, asset life = 30 years, tax rate = .46, allowed rate of return on equity = .113, interest rate on long-term debt = .0756, debt ratio = .625, and portion of deferred taxes used to replace debt = .625.

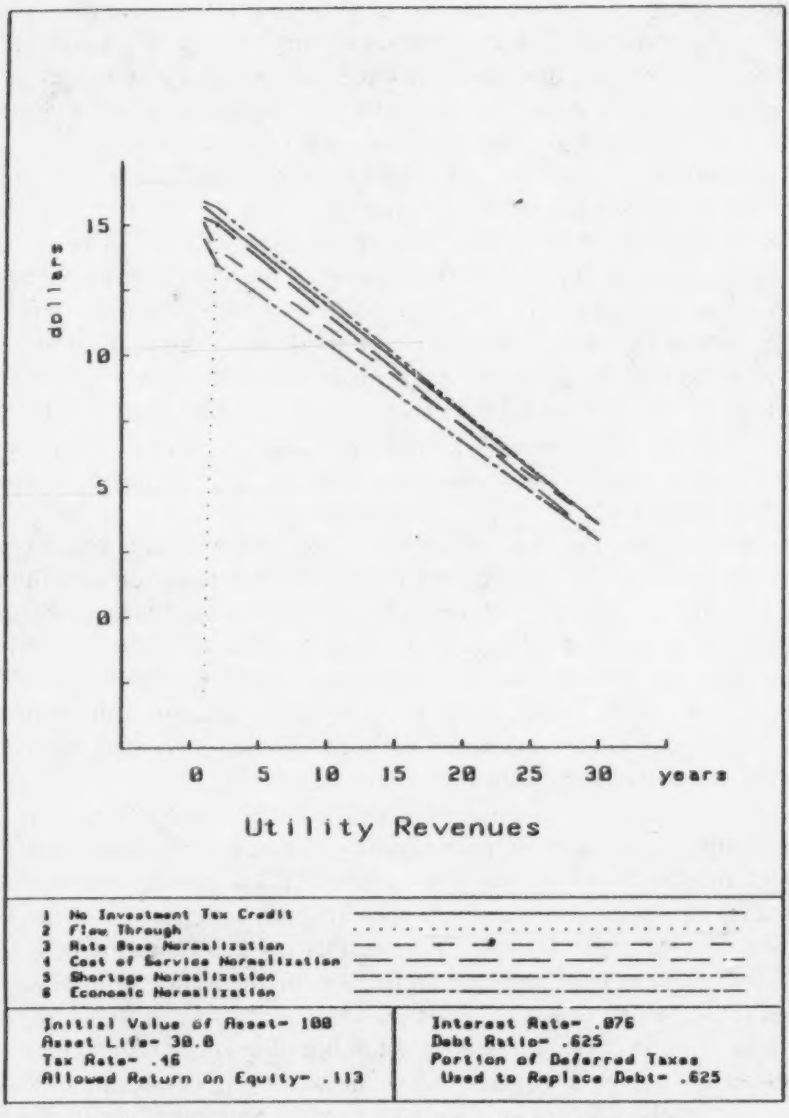

FIG. 1.—Utility revenues over the life of a $100 asset

allowable on its other assets. Every year after the first year, however, the utility revenues under flow-through treatment are identical to the base case.

Under the normalization treatments the ITC is not passed on through reduced utility rates in the first year; it is placed in the accumulated deferred investment tax credit (ADITC) account and amortized over the life of the asset. Rate-base normalization and cost-of-service normalization both yield utility rates which are lower than the base case (and flow through in every year but the first). Rate base normalization

produces lower rates than the cost of service procedure at the outset, but the effect on revenues of flowing through a pro rata share of the ITC each year eventually exceeds the effect of excluding an ever-decreasing ADITC from the rate base, so, beginning in the twentieth year, rates under cost-of-service normalization become lower.

Interestingly, under the shortage-normalization treatment utility rates are higher each year than in the base case. Thus, the procedure not only prevents utility rates from decreasing as a result of the tax benefit, it actually forces a rate increase. This effect was missed by Thompson and Weygandt, who reported merely that this treatment had no effect on utility rates but increased the rate of return in the first year. This oversight occurred because Thompson and Weygandt ignored the effect on utility revenues which results from the interaction of the tax system and the changes in the utility's capital structure produced by normalization. Under normalization, deferred taxes replace a portion of private equity and debt financing. As a result interest payments are lower than in the base case, thus producing higher taxable income and tax payments, and, in turn, forcing higher revenue requirements than in the base case. Thus, even though the mechanics of shortage normalization are designed to disregard the direct effect of the tax credit on utility rates, the effect of normalization on the utility's capital structure produces an indirect effect. The resulting net effect on utility rates is even worse for customers than Thompson and Weygandt reported; customers receive less than no benefit at all.[11]

With the exception of flow-through treatment in the first year, the lowest utility rates each year are produced by economic normalization, the treatment which both excludes the ADITC from the rate base and decreases the cost of service each year by a pro rata portion of the ITC to reflect lower depreciation. At the outset economic normalization is at least $.50 lower in annual revenues than the other normalization procedures; while this gap narrows with regard to cost of service normalization, it is maintained over the life of the asset with regard to the other normalization procedures. Interestingly, economic normalization in the last 2 years, and cost of service normalization in the last year, actually yield annual revenues which are less than depreciation (which equals $3.33 per year). This is due to the negative effect on revenues of the normalized investment tax credit, I^n, and excluding the ADITC from the rate base [in the case of economic normalization], as well as negative tax payments which result from negative taxable income when depreciation exceeds revenues (even though equity capital still earns its allowed rate of return).

11. The net direction of the effect of shortage normalization on utility rates depends on the value of e, the portion of deferred taxes used to replace debt. In the example in the text, if $e = 0$, utility rates will decline rather than increase (see the discussion of fig. 5 in text).

Thompson and Weygandt used as their single criterion for evaluating the alternative rate making treatments of the ITC the sum of the utility rate reductions (unadjusted for time value) achieved over the life of the asset compared to the base case. Table 2 reports these sums for the data in table 1. On this basis economic normalization is clearly the treatment most preferential to ratepayers; it yields aggregate utility rate reductions equal to nearly twice those associated with flow-through treatment, which yields the next largest reductions. The aggregate rate reduction under flow-through barely exceeds that under rate-base normalization, but it more substantially exceeds cost of service normalization, and, of course, shortage normalization (which is negative).

But merely summing the utility rate reductions over the life of a 30-year asset is surely an inadequate judgment criterion. Is it not relevant that the entire rate reduction under flow-through occurs during the first year of the asset's life, whereas the rate reductions under the alternative treatments are spread over the entire asset life? One method of recognizing the differences in timing under the alternatives is to calculate discounted present values of the utility rates over the life of the asset. Results of such calculations for the example data are presented in table 3; they make clear that the discount rate determines

TABLE 2 **Sums of Utility Rate Reductions under Alternative Regulatory Treatments of the Investment Tax Credit over the Life of the Asset in the Hypothetical Example ($)**

Regulatory Treatment	Sum of Utility Rate Reductions
Flow-through	18.52
Rate-base normalization	18.23
Cost-of-service normalization	12.68
Shortage normalization	−5.84
Economic normalization	36.75

TABLE 3 **Discounted Present Values of Utility Rates under Alternative Regulatory Treatments of the Investment Tax Credit over the Life of the Asset in the Hypothetical Example ($)**

	Discounted Present Values		
Regulatory Treatment	Discount Rate = .05	Discount Rate = .0703	Discount Rate = .12
Base case	170.62	143.73	101.80
Flow-through	152.98	126.43	85.27
Rate-base normalization	159.28	134.07	94.87
Cost-of-service normalization	164.76	139.19	99.05
Shortage normalization	174.25	146.83	104.02
Economic normalization	149.79	126.43	89.89

which treatment yields the lowest utility rates in terms of present value. Using a high discount rate of 12%, which attaches a high value to early benefits, flow-through treatment has a lower present value of utility rates than economic normalization. A low discount rate of 5% produces the opposite result. Equivalent present values of utility rates over the asset life for flow-through and economic normalization are obtained using a discount rate of 7.03%. The rankings of the other treatments do not vary with the discount rate; in terms of increasing present value of utility rates the ranking is rate-base normalization, cost-of-service normalization, base case, and shortage normalization.

However, the extent to which present-value analysis provides information which is directly useful in evaluating the effect on consumers of the alternative regulatory treatments is uncertain for two reasons. The first is the ambiguity regarding the appropriate consumer discount rate to use in the evaluation. For some consumers (e.g., those whose marginal investment is a passbook savings account), the appropriate discount rate would be relatively low. For others (e.g., those whose marginal expenditure is financed by consumer credit), the rate would be quite high. Given the conceptual and data limitations, arriving at the appropriate weighted average discount rate to represent this array of circumstances would inevitably be, to a considerable extent, judgmental. This difficulty is a problem only in evaluating the consumer benefits under flow-through versus economic normalization, but this is an important relationship.

The lengthy time period necessarily involved in this analysis is the second factor which undermines its relevance for policy decisions. When alternative time streams of charges or benefits to a group of customers (who are not the whole population) span a short time period, say 5–10 years, present-value analysis offers a useful means of comparing the alternatives. However, the relevant time period in this case is the useful life of the utility asset, 30 years or perhaps 40 years or more (and when the focus of the analysis is on a utility firm, rather than on a single asset, the time period is indefinitely long, as the next subsection indicates). Such time periods stretch beyond the lifetimes of many present utility customers and are certainly long enough for substantial numbers of the original group of customers to have moved to other areas serviced by other utilities. Thus, it is probable that the original group of customers will not fully benefit from the time value of the deferred tax account which accumulates under normalization treatment or share in the higher utility rates after the first year under flow-through treatment. One might usefully inquire what the benefit of flow-through treatment is to a consumer who moves into the utility's service district during the second year of the asset's life. If one of the purposes of utility regulation is to avoid subsidizing one group of customers at the expense of another, this consideration reduces the

usefulness of present-value analysis for this policy choice and emphasizes the importance of appropriate treatment on a year-by-year basis. It will be argued in the conclusion that this goal is accomplished by economic normalization.

The evaluation of the alternative rate-making treatments, of course, should be based on more than just the patterns of utility rates charged to customers. Other results which might be selected for scrutiny include the tax payments by the utility under the alternatives, the utility's cash flow, and the rate of return earned on equity. Simulation results for these variables, along with a smaller version of the revenues graph, are plotted in the four graphs in figure 2. Base-case tax payments are \$3.55 in the first year and decrease to \$0.06 in the thirtieth year. Tax payments under all the alternative treatments of the ITC are negative in the first year; the ITC more than eliminates the tax obligation. Under flow-through the first-year tax is −\$14.97; under the other treatments the first-year tax ranges from −\$6.26 (shortage normalization) to −\$6.91 (economic normalization). After the first year the pattern of tax payments tends to reflect the pattern of utility revenues, since revenue is the principal item in the taxable income equations which varies among treatments. Hence, tax payments under flow-through equal tax payments in the base case; tax payments are highest under shortage normalization and lowest under economic normalization, etc.

Interestingly, tax payments under cost-of-service normalization exceed those in the base case during the first 9 years of the simulation, then become lower than the base case, and eventually decrease below those of rate-base normalization. This is because the higher profit of the utility firm under cost-of-service normalization (compared to economic normalization) derives from inclusion of the ADITC in the rate base. The dollar magnitude of the profit benefit declines as the ADITC decreases over the life of the asset, hence the tax payments under this treatment decline over the life of the asset relative to the base case and economic normalization.

Cash flow of the utility under the base case declines linearly from \$7.50 in the first year to \$3.40 in the thirtieth year. Cash flow under flow-through treatment is equal to the base case in every year including the first. The utility firm receives no cash-flow benefit under flow-through; the entire benefit of the ITC flows through to reduce utility rates in the first year of the asset's life. Cash flow in the first year under the other treatments is higher by amounts ranging around \$10, the amount of the investment tax credit. The actual first-year cash flows under the normalization treatments range from \$16.96 under economic normalization to \$17.72 under shortage normalization. After the first year the pattern of cash flows is similar to the pattern of tax payments. Thus, shortage normalization yields cash flows which exceed those of

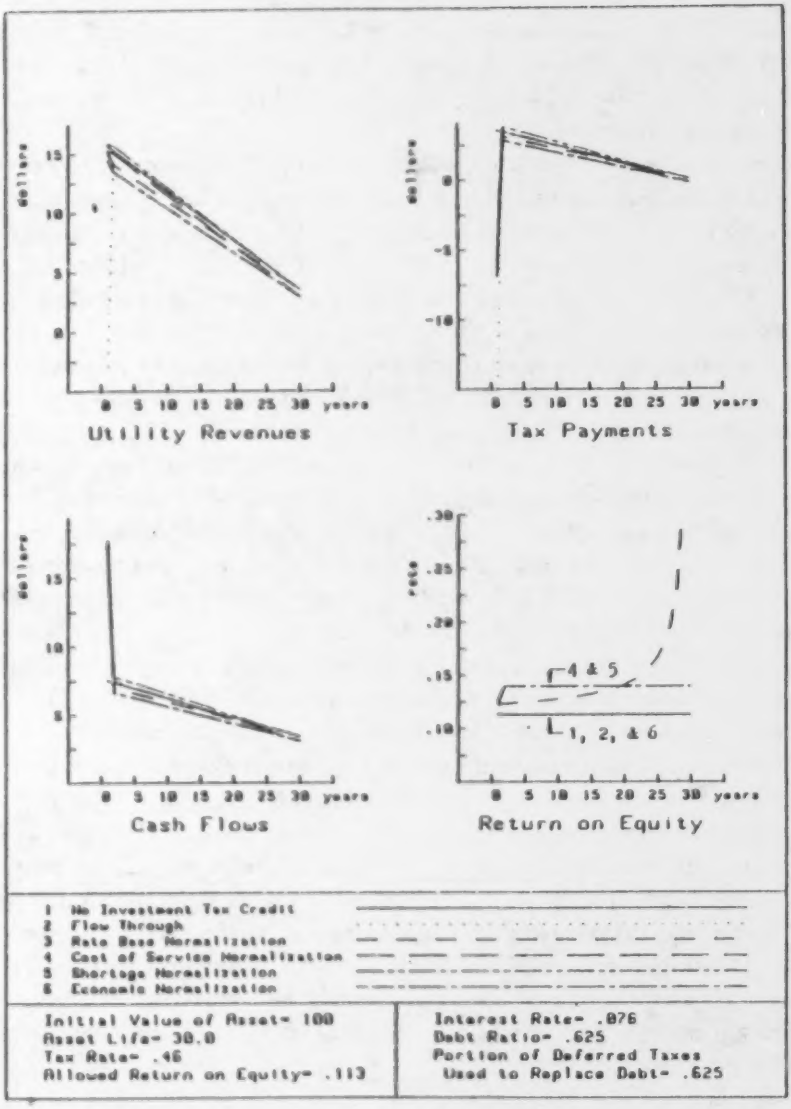

FIG. 2.—Revenues, tax payments, cash flow, and return on equity over the life of a $100 asset

the base case and flow-through, and economic normalization yields the lowest cash flows.

The final graph in figure 2 shows the rate of return on equity earned by the utility firm each year over the life of the asset under the alternative regulatory treatments. The rates of return are calculated by dividing the book profits by the average amount of equity financing each year. One seemingly reasonable standard for judging the correctness of the regulatory treatment of taxes (or other financial transac-

tions) is the following: if the regulatory authority uses the appropriate market rate of return on equity in determining the allowed rate of return for a utility, does the regulatory formula yield utility rates which generate revenues that would, in fact, provide the market rate of return on equity (disregarding economic changes—e.g., inflation—which may invalidate the data or assumptions on which the regulatory decision was based)? In other words, if the regulatory authority uses the appropriate rate of return in its regulatory decision but the treatment of taxes in the regulatory equation is such that the actual return to equity would be lower or higher than the market rate of return on equity, then the regulatory treatment of the tax expense is incorrect. By this standard only flow-through and economic normalization are appropriate regulatory treatments of the investment tax credit (this standard, of course, is inappropriate for judging shortage normalization, which is intended to provide a special subsidy).

In the return on equity graph in figure 2, the lines for the base case, flow-through, and economic normalization are coincident; they are the horizontal line at .113, the allowed rate of return on equity. Flow-through treatment yields the appropriate rate of return because the entire tax credit is passed on immediately to customers and is not allowed to affect profits. Economic normalization yields the appropriate rate of return because, while the ITC is retained and amortized over the life of the asset, the financial benefits of this procedure are passed on to customers through exclusion of the ADITC from the rate base and the flow-through of the normalized investment tax credit.

Under the other three normalization treatments the actual rate of return is higher than the regulatory commission intended to allow. Under rate-base normalization, the rate of return begins at .123 and climbs steadily upward over the life of the asset. This upward trend occurs because the higher profit under this treatment results from not flowing through the normalized ITC each year. This provides a constant amount of "extra" profit (compared to economic normalization or the base case) to the utility firm each year, and since the amount of equity financing of the asset diminishes each year as the net asset value decreases, the rate of return on equity continuously increases. Interestingly, the simulation analysis reveals that the rates of return are identical under cost of service normalization and shortage normalization. This result, which is not otherwise apparent, is easily verified using the reduced forms of the book-profit equations for the two treatments. Thus, while shortage normalization yields higher cash flows than cost-of-service normalization, in the book-profits equation the positive effect of higher revenues is exactly offset by the negative effect of higher book taxes (resulting from both the higher revenues and not reducing the book tax expense by the normalized ITC).

The results for a single asset may now be summarized. Flow-through

treatment passes on to customers the full benefit of the ITC immediately in reduced utility rates; no further rate reduction or effect on tax payments occurs after the first year. Under flow-through there is no effect on cash flow or profits of the utility firm. Economic normalization, on the other hand, allows the utility to retain the ITC and amortize it over the life of the asset. However, the utility firm is not allowed to profit from this procedure; the potential profit is passed through to customers by excluding the ADITC from the rate base and permitting the utility to depreciate only the privately financed portion of the asset (by reducing the annual cost of service by the normalized ITC). Economic normalization produces the lowest utility rates, except for flow-through in the first year of the asset's life, the lowest tax payments (with the same exception), and a rate of profit equal to that intended by the regulatory authority. It also yields the lowest cash flow for the utility firm after the first year, but this result should not be misinterpreted. All of the normalization procedures provide a jump in cash flow during the first year which enables the utility to finance 10% of the cost of the asset with the deferred tax credit, thus reducing the firm's reliance on the capital market for private financing. Economic normalization provides a cash flow which is just sufficient to maintain this 10% deferred tax credit financing over the life of the asset but which does not artificially increase the profit rate. The other normalization procedures also maintain the tax financing but also compel, through required rate making procedures, an increase in the profit rate above that intended by the regulatory authority. These higher profit rates are provided at the expense of higher utility rates and tax payments.

B. The Growing Firm

The most serious limitation of the analysis by Thompson and Weygandt is that it focuses exclusively on the regulatory effects regarding a single utility asset. But these results do not carry over directly in application to a utility firm. The plant and equipment of an ongoing firm is comprised of assets of different vintages. At any given time the tax and regulatory characteristics of a utility firm will depend, in part, on the age distribution of the utility's assets, which, in turn, depends on the utility's growth rate. Furthermore, with enactment of or eligibility for a tax benefit which applies only to new investment, such as the investment tax credit, the effect on the utility firm will change over time as an increasing proportion of the utility's capital assets have benefited from the tax provision. To explore these effects the financial characteristics of a growing utility firm under the alternative rate making treatments of the ITC have been simulated.

The utility firm growth-simulation model (described in the Appendix) assumes the utility grows at a constant annual rate. Investment sufficient to replace depreciated assets and sustain the specified growth

in average net asset value occurs instantaneously, at the beginning of each year. Seventy percent of the utility's gross investment is assumed to qualify for the investment tax credit (only machinery and equipment qualify for the ITC, not structures). As for the single asset case, the simulation parameters are set at values representative of the electric utility industry in 1978.

The growth in total net utility plant of electric utilities for the most recently reported 5 years has averaged 10.3%.[12] The simulation results for a utility firm which grows at a constant 10% rate are graphed in figure 3. To standardize the results and facilitate comparisons among simulations, the dollar amounts of the variables in the first three graphs are divided by average net assets each year; thus, the graphs actually plot rates of required revenue (utility rates), tax payments, and cash flow per dollar of capital assets.

Utility rates in the base case remain constant throughout the simulation.[13] Despite the changing level of utility rates associated with each vintage of the utility's assets, the new investment each year maintains a constant relative distribution of asset vintages (under the constant growth-rate assumption) and, therefore, constant utility rates per dollar of capital assets. Utility rates under flow-through treatment decrease significantly the first year the ITC is in effect and remain constant at the lower level. While the rates are reduced only in the first year with regard to any single asset, the immediate flow-through of the tax credit received on each year's new investment maintains the reduced utility rates for the growing utility firm.

Under the four normalization procedures the level of utility rates gradually changes over the time period equal to the average asset life and then stabilizes. During this time period the ADITC and the value of the normalized tax credit increase as new vintages of assets qualify for the investment tax credit. However, beyond the time period equal to the asset life these values will be constant relative to total net assets as long as the utility growth rate and the ITC rate remain unchanged.

As is the case for a single asset, the highest utility rates for the firm occur under shortage normalization. Cost-of-service normalization yields rates which gradually decrease from the base-case level as the normalized ITC increases. Rate-base normalization produces larger reductions in utility rates; excluding the growing ADITC from the rate base—it increases to approximately 7% of the rate base in the thirtieth year—yields bigger rate reductions than flowing through the nor-

12. The growth rates have been: 1974, 12.0%; 1975, 9.4%; 1976, 9.7%; 1977, 10.1%; and 1978, 10.1% (calculated from data in U.S. Department of Energy, 1979).

13. The capital costs of the case 1 utility exhibit an oscillating pattern in the early years of the simulation due to the cyclic investment effects of replacing the utility's initial plant. In the simulations the ITC is actually introduced during the third asset life cycle (after capital costs have stabilized) and its initial year is labeled year 1.

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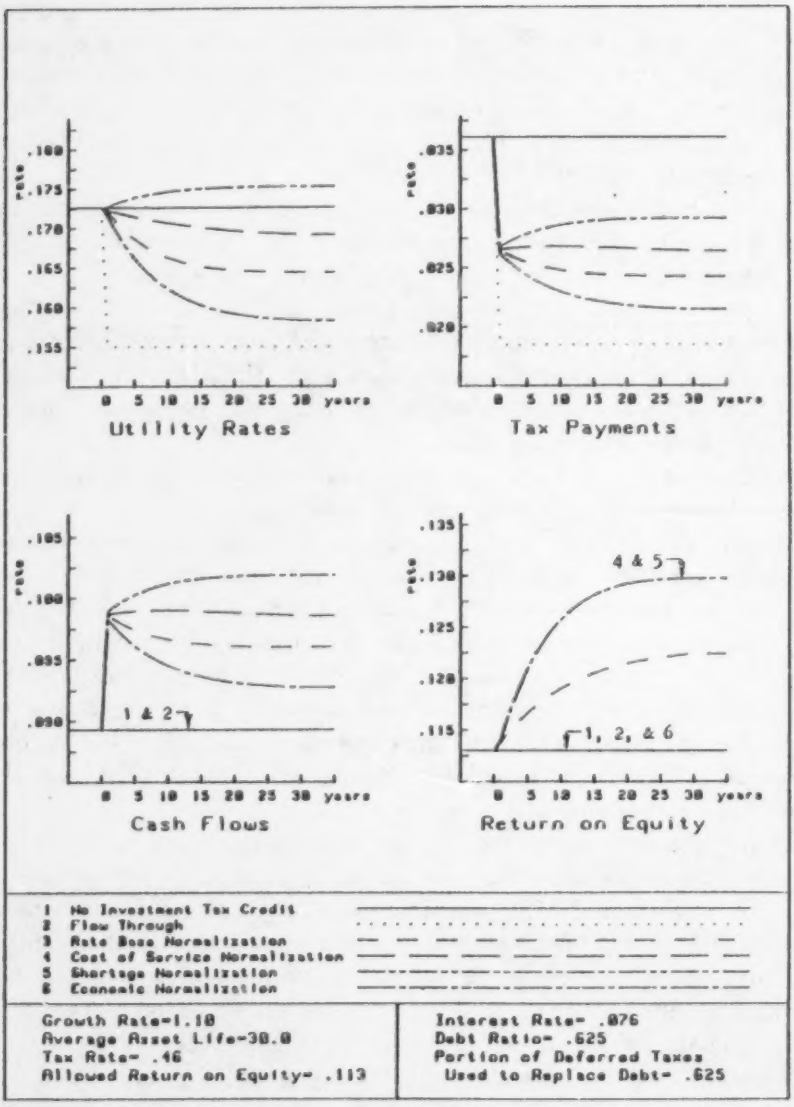

FIG. 3.—Utility rates, tax payments, cash flow, and return on equity for utility firm with a constant 10% growth rate

malized ITC. Economic normalization, which combines the two procedures, yields the lowest rates of the normalization treatments. However, for the parameters of the simulation reported in figure 3, flow-through treatment produces the lowest utility rates every year of the simulation and indefinitely into the future so long as the tax benefits continue and the parameters remain constant. This result contrasts sharply with the results for a single asset.

The implications of the alternative treatments for tax payments, cash

flow, and return on equity follow from the effects on revenues. Tax payments in the base case, like utility rates, remain constant (per dollar of capital assets) throughout the simulation. The levels of tax payments for the other cases parallel the revenue levels; shortage normalization yields the highest tax payments (obversely, the smallest tax revenue loss), and flow-through yields the lowest. In the committee reports accompanying the Revenue Act of 1971 the reason for requiring normalization treatment was stated as follows: "To permit all of the benefits of the credit to be flowed through to the customer currently could have an impact on revenues which is approximately twice that applicable in other cases."[14] The tax payments graph in figure 3 shows this statement to be correct for the first year of effect of the ITC (to which all of the examples in the committee reports referred); for later years, however, the tax revenue loss under flow-through is always greater than that under normalization, but the extent of the difference depends on which normalization treatment is being considered (and other factors, as indicated below).

The revenue and tax effects, of course, determine the cash-flow impacts of the alternative regulatory treatments. Cash flow (per dollar of capital assets) remains constant throughout the simulation in the base case and under flow-through treatment of the ITC. Since the reduction in utility revenues under flow-through treatment is exactly equal to the reduction in tax payments, there is no cash-flow effect. Cash flow under the normalization treatments jumps substantially in the first year of the ITC and then follows patterns under the various treatments which reflect the utility rate movements. Unlike the results for a single asset, in this simulation assuming 10% growth, cash flow under all the normalization treatments remains permanently higher than under flow-through and the base case. In the rapidly growing firm the cash flow resulting from the additional tax credit on new investments each year more than offsets the negative cash flow effects of amortizing the credits received on prior investments.

The profit situation for the growing firm is somewhat analogous to that for the single asset. The rate of return on equity is constant throughout the simulation in the base case and under flow-through and economic normalization. Under flow-through, the entire benefit of the ITC is passed immediately on to customers. Under economic normalization the utility receives the cash flow benefits, but the potential profit from the ITC is passed on to customers through exclusion of the ADITC from the rate base and the flow-through of the normalized ITC. As in the single asset simulation, the other three normalization treatments all yield higher rates of return on equity than the regulatory

14. U.S. Congress 1971, p. 37.

commission intended to allow. Rate-base normalization yields a higher rate of return, rising in this case from 11.3% to 12.24%, because of the failure to flow through the normalized ITC. Cost-of-service and shortage normalization yield equal significantly higher rates of return, rising to 12.97% by the end of the simulation. These two types of normalization of the ITC, the two normalization treatments which are actually in use, provide a clear and substantial benefit to the stockholders of the utilities.

The overall pattern of the simulation results for the growing firm depends on the simulation parameters. In particular, the results depend heavily on the assumed growth rate and the assumed portion of deferred taxes used to replace debt. Figure 4 shows graphs of the results for a simulation with all parameters the same as in figure 3, except the growth rate has been reduced to 6%. With the recent decreased growth in the demand for energy, a future growth rate of 6% or lower for the electric utilities may not be an unreasonable expectation. The pattern of the results in figure 4 is similar to the earlier results with one important exception: the utility rates under economic normalization drop below the rates under flow-through treatment in the twenty-second year of the simulation and remain lower thereafter. For the rapidly growing utility firm, the effects on utility rates of immediately flowing through the tax benefit always exceed the effects of amortizing the accumulated past benefits; for the slower growing firm the latter eventually overcomes the former. Parallel results have been found for accelerated depreciation.[15] Slower growth rates produce results even more different from the earlier simulation. For example, with a 2% growth rate, utility rates under economic normalization drop below those under flow-through in the fourteenth year, and the difference in rates becomes substantial by the end of the simulation. Furthermore, at this lower growth rate, tax payments and cash flow under economic normalization also decline to levels below those resulting from flow-through treatment.

The simulation results also depend heavily on the assumed portion of deferred taxes used to replace debt. Figure 5 shows the simulation results assuming a 10% growth rate, with all of the tax deferrals used to replace equity capital (or, more accurately, the tax deferrals substitute entirely for equity capital which otherwise would have had to be raised). While credit market constraints may prevent this outcome, and there is no known evidence to suggest it has occurred, it is not an unreasonable outcome to expect the utility to attempt in an effort to increase its leverage and profitability. As the graphs make clear, the results are substantially different from figure 3. Under these assump-

15. See Brigham.

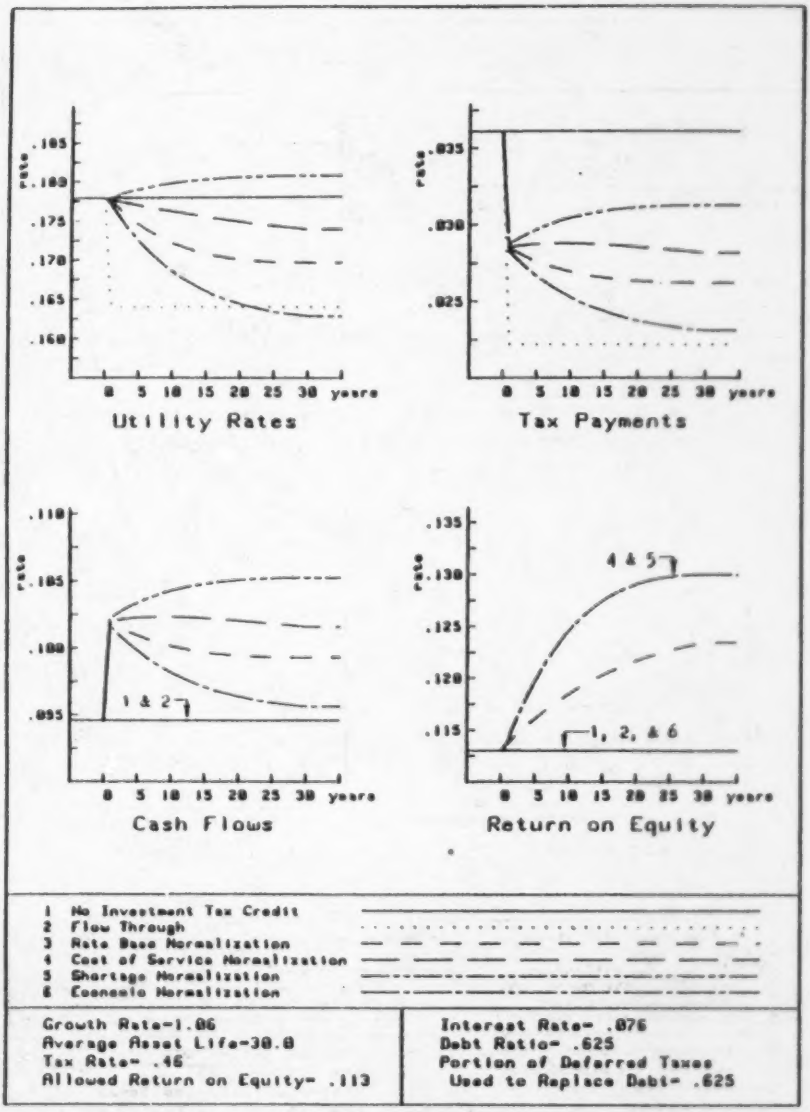

FIG. 4.—Utility rates, tax payments, cash flow, and return on equity for utility firm with a constant 6% growth rate

tions shortage normalization no longer produces higher utility rates than the base case. As in the 2% growth case, economic normalization yields lower stabilized levels of utility rates, tax payments, and cash flow than does flow-through treatment. The rate of return on equity in the base case and under flow-through and economic normalization are unchanged, but the profit rates for the other three normalization treatments are somewhat higher than in the earlier simulation.

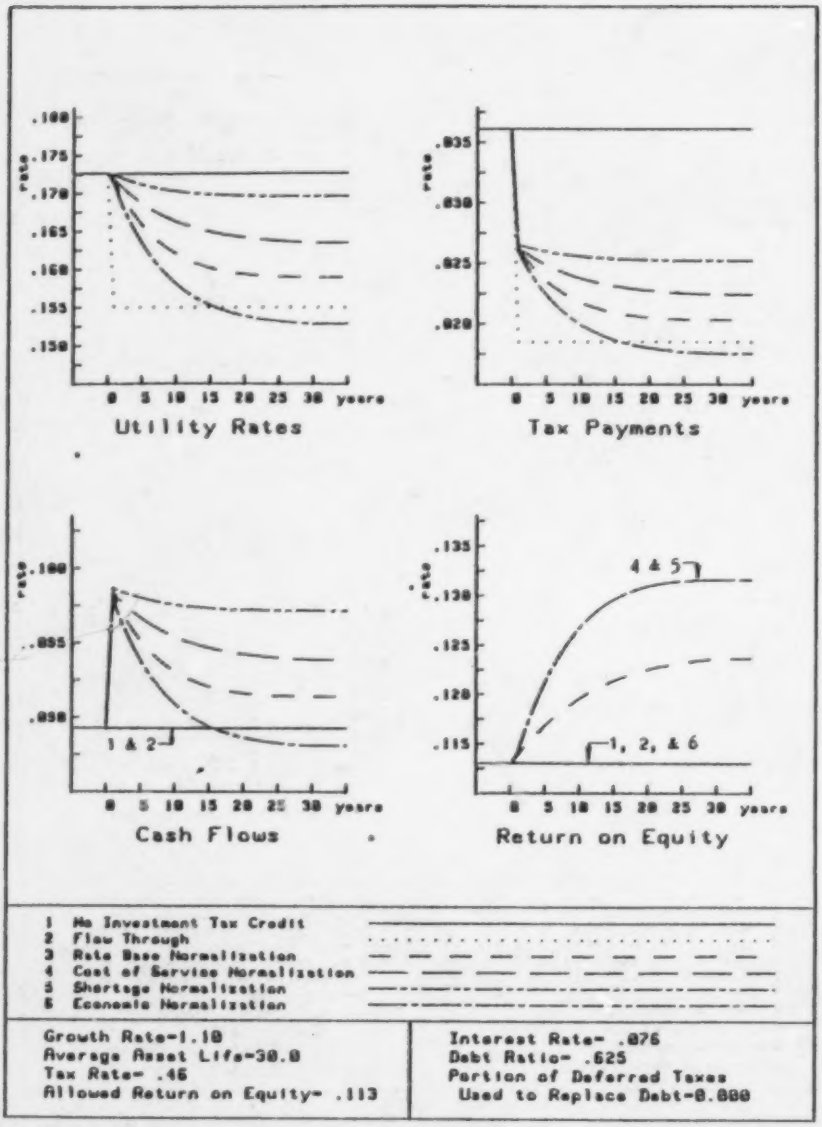

FIG. 5.—Utility rates, tax payments, cash flow, and return on equity for utility firm with a constant 10% growth rate; all tax deferrals substitute for equity capital

III. Conclusion

In adopting the investment tax credit, Congress had three goals: (1) to reduce the effective cost of acquiring new equipment, (2) to increase the profitability of new investment, and (3) that the financial assistance provided by the credit should itself be used for new investment.[16] In the unregulated sector of the economy the higher investment profitability was intended to temporarily raise the prospective rate of return above the cost of capital, thereby inducing additional investment. Once that additional investment occurred, of course, one would again expect the marginal rate of return on investment to equal the marginal cost of capital, but the reduced investment costs and cash-flow effects of the investment credit would remain. These results can be achieved in the public utility industry by the regulatory treatment referred to in this paper as economic normalization.

Thompson and Weygandt favor flow-through treatment and object to normalization of the ITC for two reasons: normalization increases the rate of return of the utility above that intended by the regulatory authority, and it yields higher utility rates than flow-through treatment. They also suggest that it is inappropriate or futile to attempt to stimulate investment in the public utility industry because public utilities "are required to provide assets sufficient to provide service for those who demand it and this amount is independent of whether or not the utility can take advantage of the investment tax credit" (p. 508). The analysis in this paper shows that the rate-of-return objection is valid for the methods of normalization of the ITC presently allowed in the tax code[17] but not for economic normalization. This was acknowledged in the Thompson and Weygandt paper in a brief reference to what the present study has termed economic normalization: "Under this approach there would be no *additional* rate of return to the stockholder and the ratepayer would benefit by both the capital structure effects and the credit effect" (p. 517). By not providing the utility a higher rate of return, economic normalization avoids the criticism of inappropriately stimulating public utility investment, but it facilitates the high levels of utility investment by increasing cash flow and providing an interest-free source of capital.

By Thompson and Weygandt's criterion for evaluating the utility rate effects—the aggregate rate reduction over the life of a single asset—economic normalization is superior to flow-through. However, this study has questioned this criterion and demonstrated that in a more relevant setting—that of a growing utility firm—the regulatory treat-

16. See U.S. Congress 1962, pp. 11–12.

17. A higher rate of return is not a necessary result, however, of the methods of normalizing accelerated depreciation which are allowed in the tax code (see Kiefer 1979).

ment which provides lower utility rates in the long run depends on the growth rate of the firm and the effects of the deferred investment credits on the capitalization structure of the firm, among other variables. But price minimization is not the principal criterion for judging appropriate accounting or rate making treatment. If it were, several other transactions would be accounted for differently. For example, including plant removal expenses as a cost of service only when incurred would yield lower utility rates than the more standard practice of amortizing these costs over the life of the plant. But the logic of the accounting process requires that the costs of capital services be related to the income produced by the capital by amortizing the capital costs over the lives of the capital assets. This same logic requires that the investment tax credit, the receipt of which is intrinsically related to the acquisition of capital assets, be normalized over the lives of the benefiting assets.

Economic normalization is consistent with the logic of regulatory accounting. It spreads the financial effects of the investment tax credit over the lives of the underlying assets. It benefits the utility companies through higher cash flow, while avoiding a rate of return higher than deemed appropriate by the regulatory commission. And it provides appropriate utility rate reductions to customers on a year-to-year basis by reducing utility revenues by amounts which accurately reflect the provision of cost-free capital to help finance the utility's investments.

Appendix

This appendix summarizes the basic structure of the simulation models used in the analysis. Since the models share most of their equations, they are presented jointly and their differences are highlighted.

At the beginning of the first year of the simulation ($t = 1$) the gross asset value, G_t (of the asset, in the case of the asset simulation model, and of the firm, in the case of the firm growth simulation model), is set equal to an initial value. This initial value also equals investment in the first year, I_1. Gross asset value remains constant throughout the simulation in the asset model ($G_t = G_1$). In the growth model the values of G_t for years $t > 1$ are given by:

$$G_t = G_{t-1} + I_t \qquad A \geq t > 1,$$

$$G_t = G_{t-1} + I_t - I_{t-A} \qquad t > A,$$

where I_t is investment at the beginning of year t and A is the useful life of the utility's assets. These equations add each year's investment to the firm's gross asset value and deduct retired assets.

Net asset value at the beginning of year t, Nb_t, is determined by the following equations in the asset model:

$$Nb_1 = G_1$$

$$Nb_t = Ne_{t-1} \qquad t > 1,$$

where Ne_t is net asset value at the end of year t. In the growth model, Nb_t is determined as follows:

$$Nb_1 = I_1$$

$$Nb_t = Ne_{t-1} + I_t \qquad t > 1.$$

Since depreciation is straight line, its value, D_t^s, is determined by the following equation in both models:

$$D_t^s = \frac{G_t}{A}.$$

Accumulated depreciation through year t, Ad_t, is given by:

$$Ad_t = Ad_{t-1} + D_t^s \qquad A \geq t > 1$$

$$Ad_t = Ad_{t-1} + D_t^s - I_{t-A} \qquad t > A$$

Only the first equation is applicable in the asset model.

Net asset value at the end of year t, Ne_t, is yielded by:

$$Ne_t = G_t - Ad_t.$$

Average net asset value during year t, Na_t, equals:

$$Na_t = \frac{Nb_t + Ne_t}{2}.$$

The amount of the investment tax credit, I_t^a, is determined by:

$$I_t^a = c \cdot I_t \qquad t \geq t^*,$$

where c, the effective rate of the tax credit, is equal to .1 in the asset model and .07 in the growth model, and t^* is the first year of effectiveness of the tax credit. The normalized investment tax credit, I_t^n, is given by the following:

$$I_t^n = I_{t-1}^n + \frac{I_t^a}{A} \qquad t^* + A > t \geq t^*,$$

$$I_t^n = I_{t-1}^n + \frac{I_t^a}{A} - \frac{I_{t-A}^a}{A} \qquad t \geq t^* + A.$$

The accumulated deferred investment tax credit (ADITC) at the end of year t, Be_t, equals:

$$Be_t = Be_{t-1} + I_t^a - I_t^n.$$

The average ADITC during year t, B_t, is given by:

$$B_t = \frac{Be_{t-1} + Be_t}{2}.$$

In the growth model the amount of investment at the beginning of each year, I_t, is determined by:

$$I_t = \frac{2 \cdot Na_{t-1} \cdot R - Ne_{t-1} + Ad_{t-1} - G_{t-1} \cdot \left(1 - \frac{1}{A}\right)}{2 - \frac{1}{A}} \qquad t \geq 2,$$

where R is the specified growth rate in average net asset value of the firm.

Values for utility revenues, taxable income, tax payments, cash flow, and profits for each year under each regulatory treatment of the investment tax credit are calculated using the data generated by the simulation models described above and reduced forms of the equations displayed in the text.

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Chairman ROSTENKOWSKI. Thank you, Mr. Kiefer.

Mr. Stark will inquire.

Mr. STARK. Thank you.

In summary, if normalization, as I add it up here, had been in effect in 1980, rates would have been about $2.3 billion lower. Profits and/or cash flow, which I suppose are hard to determine, would have been $1½ billion lower, and tax collections would have been $1½ billion lower, so that there is kind of an entropy in there of $700 million that slipped through the cracks.

In the long run, for the health of the utilities there isn't really much difference, is there, between normalization and the provisions in my bill?

Mr. KIEFER. I am sorry, Mr. Stark, between normalization under your bill and normalization under present law?

Mr. STARK. Right.

Mr. KIEFER. In the long run there is a small difference but it is not a gigantic difference. It would make some difference, obviously to the utilities; their cash flow and profits would be reduced somewhat. But the debate historically has been between normalization and flow-through; there is certainly a much smaller difference than that debate entailed.

Mr. STARK. Thank you very much for spreading some light on a very complex issue and I think putting it in its proper perspective. I appreciate it.

Mr. MATSUI [presiding]. Mr. Frenzel?

Mr. FRENZEL. No questions .

Mr. MATSUI. Mr. Rousselot?

[No response.]

Mr. MATSUI. We thank you very much for appearing here.

Mr. KIEFER. Thank you very much, Mr. Matsui.

Mr. MATSUI. At this time we will call a panel of four witnesses, Mr. Dalenberg, Mr. Watts, Mr. Topper, and Mr. Curtis.

Gentlemen, without objection we will receive your written testimony for the record and at this time I first call upon Mr. Dalenberg to testify.

STATEMENT OF ROBERT V. R. DALENBERG, VICE PRESIDENT AND GENERAL COUNSEL, PACIFIC TELEPHONE & TELEGRAPH CO. AND ON BEHALF OF AMERICAN TELEPHONE & TELEGRAPH CO.

Mr. DALENBERG. Thank you very much. I am Robert Dalenberg, general counsel of Pacific Telephone & Telegraph Co., and I am here on behalf of Pacific Telephone, AT&T, and the other Bell System companies.

If I may, I might just take a minute to make a little bit of a summary of what I say in my prepared testimony and to maybe make a point which addresses some of the questions that have gone before me.

We think that if this legislation is adopted that there is every reason to believe that this 10- or 15-year period of controversy over the normalization rules in California will be brought to a close.

And If I can put this legislation in my words rather than in tax language, the statute really does two things: It says to the world

that this is the rule of normalization that the Congress holds to and it explains specifically what is not normalization .

It then does a second thing and it says that the utilities who have sought for many years to have this clarified and have the law established and who now face several billion dollars of tax liability for the period prior to 1980 will be relieved of at least the immediate payment of that tax liability.

You, of course, recognize that about two-thirds of that liability will be paid in any event over the normal course of time.

Now, with those two things, we think, because the California Commission is the leader in this area, will conclude that normalization is correct and conclude that normalization in accordance with the congressional intent will be followed in California.

Now, why do I say that?

Last year's tax law, as we all know, requires normalization for all of the utilities. The California Commission has applied it and applied it correctly to the utilities in its recent orders. It has held out at least to Pacific and I believe as to General Telephone, it has held out clearly that we must complete either litigation relating to the earlier years which will take us many, many years to do, or that we must obtain clarifying appropriate legislation before it can really close the book on this.

We think if this legislation is passed, California will embrace normalization. It will lead the rest of the country and this long series of cases in this controversy will finally be closed. And on that basis we strongly support H.R. 1524 as it is written.

Mr. MATSUI. Thank you, Mr. Dalenberg.

[The prepared statement, with attachments, follow:]

STATEMENT OF ROBERT V. R. DALENBERG, VICE PRESIDENT AND GENERAL COUNSEL, PACIFIC TELEPHONE & TELEGRAPH CO.

I am pleased to appear before you today to testify in support of H.R. 1524 on behalf of the American Telephone and Telegraph Company, Pacific Telephone and Telegraph Company and the other Associated Companies of the Bell System (listed on Attachment A). H.R. 6503 has also been included in these hearings. My testimony is in opposition to H.R. 6503.

H.R. 1524 provides clarification of the requirements for public utilities with respect to the Investment Tax Credit and liberalized tax depreciation. It further provides that deviations from the statutory language as clarified (for periods prior to March 1, 1980) shall not result in a penalty, through forfeiture of eligibility for the Investment Tax Credit and liberalized tax depreciation.

This bill is essentially identical to H.R. 6806 which was favorably voted out of this Committee and passed by the House of Representatives by voice vote in the second session of the 96th Congress. Unfortunately, Congress adjourned before it could clear the Senate. We strongly urge this Committee to approve the bill.

Background of Controversy

Some background is essential to an understanding of the issues addressed by H.R. 1524 and the propriety and urgency of their resolution through this bill.

Public utilities are penalized through forfeiture of liberalized tax depreciation and Investment Tax Credit if the normalization requirements of Sections 46(f) and 167(l) of the Internal Revenue Code are not met. These penalties have been enacted to ensure that the Congressional objectives of providing incentives for capital investment through these tax benefits can be attained. A need for their clarification has arisen from conflicting interpretations by the California Public Utilities Commission (CPUC) and the Internal Revenue Service (IRS).

In rate orders involving The Pacific Telephone and Telegraph Company ("Pacific") which took effect prior to February 13, 1980, the CPUC used a methodology for treating

Investment Tax Credit and liberalized tax depreciation which it considered to be in compliance with the terms of Sections 46(f) and 167(l). The IRS, on the other hand, has ruled that the CPUC's ratemaking treatment in these orders violates those sections.* The result of this conflict is that Pacific, potentially, faces penalties in the form of retroactive ineligibility to claim liberalized tax depreciation and Investment Tax Credit. For Pacific, this amounts to approximately $1.7 billion in back tax liabilities with the effects of after-tax interest as of December 31, 1981.

From the outset, Pacific strenuously objected to the CPUC's methodology for fear that the Commission's actions could jeopardize its eligibility. For this reason, Pacific made every possible effort to avoid implementation of the CPUC orders which have caused this potential penalty. The Company exhausted every available legal avenue, including petitions to the United States Supreme Court. Despite these efforts, no court has ever passed on the question of whether these orders are consistent with federal law, and the CPUC's orders became final with the questions of their effect on Pacific's tax liability still unresolved. In September 1979, on the basis of the CPUC's orders, the IRS assessed an $89 million tax deficiency plus interest of $28 million against Pacific for the tax year 1974.

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*Private letter rulings no. 7836038 (6/8/78) and 7843065 (7/27/78).

Years subsequent to 1974 are still subject to audit. Pacific paid the asserted 1974 deficiency in February 1980 and recently filed a claim for refund of that amount with the Service. If the IRS denies the refund claim, Pacific intends to contest the deficiency in court but final judicial determination can be expected to require many years.

In view of these uncertainties, the CPUC ordered that from February 13, 1980 forward Pacific's customers are to pay rates on a basis clearly consistent with the normalization requirements of the tax law. However, that CPUC order also provides that customers may be entitled to refunds if it is subsequently determined that the CPUC's previous methodology is not in violation of the normalization requirements.

In the interim, however, the Company is placed in the paradoxical situation of already having made refunds to customers (over $320 million) on the assumption that the CPUC's previous methodology does not render Pacific ineligible for the past tax benefits, while at the same time facing the possibility of forfeiting to the government all of the past tax benefits (more than $1.7 billion including interest) on which those refunds were based. Furthermore, because the CPUC maintains that its methodology does not result in ineligibility for the tax benefits, the ratemaking process continues to

assume the Company's eligibility for liberalized depreciation and Investment Tax Credit, notwithstanding the IRS rulings.

The dilemma in which the Company finds itself is an unjust situation. It is caught in the middle of a conflict between the CPUC and the IRS, facing penalties not for its own actions, but for the actions of its regulatory authority.

Already the controversy and the attendant uncertainties have had adverse financial impact. Pacific has the lowest bond rating in the Bell System. It is questionable, and in fact it may be impossible for Pacific to finance such a staggering back tax liability and at the same time finance the facilities required to serve properly the customers of California. Indeed, it would be tragic if the underlying intent of the ITC and accelerated tax depreciation provisions to stimulate investment were undermined through misinterpretation to such an extent that the Company's ability to finance required facilities were severely impaired, causing irreparable harm to the Company and its customers alike.

This controversial situation also involves two other similarly situated California utilities (General Telephone Company of California and Southern California Gas Company). The controversy has already spanned almost a decade. Absent legislation, there is no way to resolve it short of lengthy and

complex litigation between the Companies and the IRS. This can take many years and the length of time involved to litigate the question is particularly harsh because it casts a lingering shadow of uncertainty over the financial position of the telephone companies and their ability to provide facilities required for communications services so essential to the economy of California.

Moreover, litigation alone cannot provide a satisfactory resolution of this problem. There is no doubt that utility commissions in states other than California will follow closely any litigation which the utilities are obliged to undertake. There can be no winner in such a confrontation: a victory by the IRS would impose harsh penalties on the companies and their customers, while a contrary decision would only encourage other jurisdictions to seek to defeat the Congressional purpose underlying the normalization requirements.

Why H.R. 1524 is Needed

The proposed legislation is the most viable solution since it provides the assurance, which litigation cannot, of a resolution satisfactory to all concerned. In making it clear that only strict adherence to the normalization requirements will be allowed in the future while eliminating the harsh

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penalty for the past, H.R. 1524 is consistent with and furthers the intent of Congress embraced in the normalization requirements.

As to details of the bill itself, H.R. 1524 is essentially identical to H.R. 6806 which was favorably voted out of this Committee and passed by the House of Representatives by unanimous voice vote in the last session of the 96th Congress. H.R. 6806 was then approved by the Senate Finance Committee and reached the Senate floor on the final day of the 96th Congress. It failed to become law because of the objection of a single senator, who objected not in opposition to the bill but because he was unable to attach an unrelated bill to it as an amendment.

Very briefly, the bill would clarify the normalization requirements of I.R.C. Sections 46(f) and 167(l) so that any misunderstanding of their meaning can be avoided in the future. It includes specific language which would make it clear that the methodology employed by the CPUC in the past does not comply with the law. In addition, the Secretary of the Treasury is given explicit authority to prescribe by regulation procedures and adjustments which will be deemed inconsistent with normalization, in addition to those already specified in the statute.

There is a special rule for periods before March 1, 1980 which, in effect, provides that the California methods will not retroactively result in penalties for Pacific, General Telephone Company of California and Southern California Gas Company. However, the March 1, 1980 date assures that such relief will apply only to misinterpretations occurring in the past and will not provide exceptions to California or any other jurisdictions thereafter.

It will be clear from the legislative history of the bill that further relief for future violations of the normalization requirements cannot be expected. In addressing the special rule providing limited relief, the Report of the Ways and Means Committee accompanying H.R. 6806, July 30, 1980, page 11 states as follows:

> This special rule is designed to meet a specific, one-time problem which has arisen as a result of misapplication of the normalization rules in certain California cases. The committee remains convinced that the normalization rules provided in the Code are appropriate for public utilities and does not intend that the provision of relief in this instance should be regarded as a precedent for similar relief in subsequent incidents.

We believe H.R. 1524 is fully deserving of this Committee's support. It contains the same language as the bill that was introduced as H.R. 6806 in the 96th Congress on March 13, 1980, generally receiving the full support of Congress. Since then, the Economic Recovery Tax Act of 1981 (ERTA of 1981) has been enacted. However, the need for H.R. 1524 still

remains. In fact, the ERTA of 1981 reinforces the need for H.R. 1524 because in that legislation Congress has reaffirmed its commitment to the normalization requirements through their continuation and expansion to include even those utilities which had been excepted from the requirements under prior law.

In considering the ERTA of 1981, the Congress recognized the continuing need for this legislation. As an interim solution, the ERTA of 1981 includes a provision which specifically grants the Secretary of the Treasury authority to prescribe interim regulations with respect to normalization under the accelerated cost recovery system until Congress acts further. In proposing this particular provision, Senator Cranston made the statement with respect to S. 232, the Senate companion bill to H.R. 1524, "The amendment I am offering will not affect the overall objective of S. 232 in any way whatsoever". Senator Dole responded to the concerns raised by Senators Cranston and Hayakawa for action on S. 232:

> "Mr. President, let me say to both distinguished Senators from California that, certainly, the Senate Committee on Finance, in our role on the measure, will give every consideration and do all we can to expedite the resolution of this very serious concern of both Senators."

While the passage of the ERTA of 1981 in no way diminishes the need for H.R. 1524, it should be noted that since this bill was introduced prior to the enactment of the ERTA of 1981, a conforming amendment to the bill will be

necessary to reflect new Section 168(e)(3) of the Code. A suggested amendment is attached at the end of this statement (Attachment B).

In summary, H.R. 1524 provides a timely response to the pressing needs:

1) An end to the California controversy and the attendant financial and economic problems, and
2) Clarification of the normalization requirements to avoid future misinterpretation, in California and elsewhere.

The limited relief provided by this legislation is appropriate as a remedy to the unfortunate plight of the affected California utilities. Without such relief, Congress' objectives of stimulating investment would be frustrated. There is little to be gained, and much to be lost, if the affected utilities incur the massive penalties and forfeitures which must be paid according to the IRS rulings. The relief H.R. 1524 would grant does not confer favored treatment - it merely restores the affected companies to parity with other taxpayers whose eligibility for the tax benefits has not been placed in jeopardy. At the same time, Congress' message is clear - nothing less than strict adherence to the normalization requirements will be allowed.

For these reasons, we respectfully urge this Committee to support H.R. 1524.

H.R. 6503 Should be Rejected

I would like now to address the other bill being considered here today, H.R. 6503, introduced by Congressman Stark. This bill is interesting on three accounts - for what it does, for what it doesn't do, and for what it seeks to undo.

Section 1 of H.R. 6503 seeks to undo the work of several Congresses and subvert the intent of present Code provisions dealing with the Investment Tax Credit as it applies to the public utility industry. It would do this by eliminating the requirement that eligibility of public utilities for the Investment Tax Credit is conditioned on a sharing of the benefit between customers and investors in regulated utilities.

The bill does provide limited relief to those companies caught in the conflict between the CPUC and the IRS. Section 2 of H.R. 6503 is identical to the special rule in H.R. 1524 that provides that the California methods will not retroactively result in penalties for Pacific, General Telephone of California, and Southern California Gas Company.

However, the bill does not clarify the normalization requirements of I.R.C. Sections 46(f) and 167(l). This is a critical omission. Without the vitally important clarification language of H.R. 1524 there is no assurance that the conflict that brings us here today will not reemerge in the form of similar misunderstandings in the future. The failure of H.R. 6503 to address the clarification issue is, in our opinion, a fatal flaw.

Section 1 of H.R. 6503 would strip away the sharing concept and remove the incentive effect of the Investment Tax Credit for public utilities. No action as extreme as this should be taken without full consideration of Congressional intent in establishing the Investment Tax Credit - the stimulation of investment by enhancing the profitability of newly acquired depreciable assets.

To assure that this goal will be achieved in the case of regulated public utilities, Congress established eligibility rules which are now contained in Section 46(f) of the Code. Under these rules utilities pass on the Investment Tax Credit to their customers ratably over the life of the plant which generated the credit, and then earn a return on the facilities purchased with the unamortized portion of the credit. Thus, an investment of $100,000 in eligible plant would generate a tax

credit of $10,000. If the $10,000 credit is invested in plant which has a life of 10 years, customers will receive a benefit of $1,000 each year for ten years, and the company would be entitled to earn a return on that portion of the plant represented by the unamortized portion of the credit.

This sharing of the benefit was mandated by Congress explicitly to assure that the credit fulfills its purpose of capital formation and investment incentive while still allowing regulatory commissions to pass the amount of the credit on to utility customers.

The Report of this Committee on what is now section 46(f) of the Internal Revenue Code, specifically stated that "it is appropriate to divide the benefits of the credit between the customers of the regulated industries and the investors in the regulated industries", noting that "this represents the best balancing of the considerations of both investors and customers of the regulated companies".* For a regulated utility there is no increased investment incentive unless the utility is allowed to share in the benefits of the Investment Tax credit.

As an example, assume a business is considering the purchase of new equipment which costs $100,000 and which is expected to generate a return of $10,000, or 10%. Assume

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*H.R. Rep. No. 92-533, 92nd Cong., 1st Sess. (1971) p. 24.

further that the investment is discretionary on the basis of its risks relative to the expected return and that a 10% return is marginally unattractive. With a 10% Investment Tax Credit the effective cost of the equipment is reduced to $90,000, and the return on the capital supplied by the firm would rise from10% to 11.1%. This higher return might be sufficient incentive to warrant the investment. However, if the firm is denied the opportunity to earn the higher return on its capital, it would have no additional incentive to purchase the equipment. The Investment Tax Credit would increase internal cash generation, but this, in and of itself, would not make the investment more attractive.

To assume there is an investment advantage in that example would be the same as saying that an investor, who would not elect to invest $100,000 in a savings account at a 5% return because the return was too low, would put $90,000 into the savings account at a 5% return because the overall amount invested was lower.

The only incentive either to the savings depositor -- or to an investor -- from an Investment Tax Credit arises where the investor is allowed to earn on the entire $100,000 investment, thus enhancing the profitability of the investor's funds. Moreover, the investor would have even less incentive

than the savings depositor to make a $90,000 investment with no opportunity to increase profitability, because it would have all of the additional burdens and risk involved in administering the additional investment provided by the Investment Tax Credit with no compensation for assuming these burdens and risks.

Section 46(f) provides for an equitable sharing of the Investment Tax Credit. That sharing is generally accomplished in one of two ways:

1. by reducing the base upon which the utility earns but not reflecting the investment credit as a reduction of its cost of service; or

2. by reducing cost of service, over the life of the property, by the amount of the credit, but not reducing the rate base upon which the utility earns.

The Bell System has adopted the second of these methods. Our customers benefit by receiving the benefit of reduced rates over the life of the property which generated the credit, and our shareholders benefit by our ability to earn on

the unamortized credit balance while utilizing the funds provided for capital investment. The lessened reliance on costly external sources of capital allows additional modernization investments which improve productivity and hold prices down.

H.R. 6503 raises a very substantial and significant issue for regulated utilities. Section 1 would repeal the sharing concept of present law by allowing regulatory commissions to deduct the investment credit from a utility's rate base while also ratably amortizing the credit to income. This would be a radical change from the intent of Congress.*

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*H. Rep. No. 92-533, 92nd Cong., 1st Sess. (1971) p. 24 stated that: ". . . the basic purpose of the investment credit is not an allocation of resources which will stimulate consumption of any particular type of product or service."

S. Rep. No. 1881, 87th Cong., 2nd Sess. (1962) p. 11 stated: "The objective of the credit is to reduce the net cost of acquiring new equipment; this will have the effect of increasing the earnings of new facilities over their productive lives and increasing the profitability of productive investment . . . "(emphasis supplied.)

In the various revenue acts dealing with the investment credit since its inception in 1962, Congress has steadily moved toward providing parity in the treatment of regulated and unregulated industries. The allowable percentage is now the same for all industries, and Section 46(f) (by providing for the sharing of the credit between customers and investors) assures utilities at least a portion of the investment incentive which is available to non-regulated industry. The sharing concept in Section 46(f) clearly results in a dilution of the full benefits of the investment credit -- a dilution we believe is appropriate. However, it is by no means clear that unregulated industry shares the credit with its customers in the form of lower prices. What is clear however, is that regulated utilities do. In 1981 our rates were reduced by one billion dollars through the amortization of investment credit. We do not believe that regulated utilities, which today receive only partial benefits of the credit, should now become the only industry which will be denied any benefits of the credit.

This attempt to repeal the sharing concept is not new. Section 1 of this bill is identical to H.R. 3165 in the last Congress. In April, 1980 this committee overwhelmingly rejected H.R. 3165 by a vote of 28 to 6. Again last year the idea of repealing the sharing concept resurfaced, this time as

a "technical amendment" to H.R. 2400, an early Administration version of the bill that eventually became the Econmomic Recovery Tax Act of 1981. The Administration reconsidered its "technical amendment" and withdrew it from the legislative proposal.

Now, once more, we are looking at the same concept; but there is no new evidence to suggest that this approach has any more merit today than it did in 1980 or 1981. We are still convinced that the current law provisions of Section 46(f) - carefully forged by several Congresses over almost two decades - are in the best interests of all concerned.

In summary, we oppose H.R. 6503 because it

1. is contrary to Congressional intent in adopting the Investment Tax credit;

2. is contrary to Congressional intent in providing a sharing of the credit.*

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*H.R. Rep. No. 92-533, 92nd Congress, 1st Sess. (1971) p. 24 specifically states ". . . it is appropriate to divide the benefits of the credit between the customers . . . and the investors . . . this represents the best balancing of the considerations of both investors and customers of the regulated companies."

3. is contrary to the overall thrust of the Economic Recovery Tax Act of 1981 which was to increase capital investment incentives.*

4. fails to provide the essential clarification of the normalization requirements of Sections 167(l), 168(e)(3), and address the very misunderstanding that led to the need for these hearings today.

We respectfully urge the members of this Committee to reject H.R. 6503 and to support H.R. 1524.

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*It is interesting to note that an unintended result of this legislation would be a decrease in Federal revenues. If utilities no longer earn on the unamortized portion of investment credit, utility revenues, taxable income and Federal taxes will decrease.

ATTACHMENT A

BELL SYSTEM COMPANIES

American Telephone and Telegraph Company
The Bell Telephone Company of Pennsylvania
The Diamond State Telephone Company
Bell Telephone Laboratories, Incorporated
The Chesapeake and Potomac Telephone Company
The Chesapeake and Potomac Telephone Company of Maryland
The Chesapeake and Potomac Telephone Company of Virginia
The Chesapeake and Potomac Telephone Company of West Virginia
Cincinnati Bell, Incorporated
Illinois Bell Telephone Company
Indiana Bell Telephone Company, Incorporated
Michigan Bell Telephone Company
The Mountain States Telephone and Telegraph Company
New England Telephone and Telegraph Company
New Jersey Bell Telephone Company
New York Telephone Company
Northwestern Bell Telephone Company
The Ohio Bell Telephone Company
Pacific Northwest Bell Telephone Company
The Pacific Telephone and Telegraph Company
and Bell Telephone Company of Nevada
South Central Bell Telephone Company
Southern Bell Telephone and Telegraph Company
The Southern New England Telephone Company
Southwestern Bell Telephone Company
Western Electric Company, Incorporated
Wisconsin Telephone Company

ATTACHMENT B

The following changes in H.R. 1524 are recommended to reflect the changes in the Internal Revenue Code affected by the Economic Recovery Tax Act of 1981.

1. page 1, line 5,
   insert "(a)" before "Paragraph".

2. page 3, line 4,
   insert, before section 2, a new paragraph, as follows:
   "(b) Paragraph (3) of section 168(e) of the Internal Revenue Code of 1954 (relating to definitions for purposes of depreciation in the case of utilities) is amended -
   (1) by redesignating subparagraph (C) as subparagraph (D), and
   (2) by inserting after subparagraph (B) a new paragraph identical to subparagraph (H) of section 167 (l)(3) of the Code (as amended by section (1)(a) of this Act, except that

   (i) the new subparagraph under section 168(e)(3) shall be designated as subparagraph (C), instead of (H), and
   (ii) the words "subparagraph (B)" shall be inserted in place of "subparagraph (G)" wherever such latter words appear in section 157 (l)(3)(H), as amended.

3. page 4, line 12.
   insert "(a)" after "1".

Mr. MATSUI. Mr. Watts.

STATEMENT OF GLENN E. WATTS, PRESIDENT, COMMUNICATIONS WORKERS OF AMERICA, AFL-CIO

Mr. WATTS. As you already know, I represent the Communications Workers of America. We have something in excess of 650,000 members across the country who work in the telecommunications industry.

CWA represents the bargaining unit rights in California which are of particular interest to us in this case of well over 65,000 employees of the Pacific Telephone & Telegraph Co. and some 18,000 workers employed by the General Telephone Co. of California.

It is our opinion that failure to enact H.R. 1524 will seriously affect those employees of the company and our union members in a number of ways.

First, and most important, should the telephone companies not receive the tax normalization embodied in H.R. 1524, I can predict there will be thousands of layoffs of telephone workers and a resultant cutback in services as the telephone companies attempt to reduce their costs to meet this potential tax burden.

In these times of 9.5 percent unemployment, I don't think anyone wants to see additional workers on the unemployment rolls.

Second, although I can't speak directly for them, there are thousands of workers in hundreds of companies that benefit from telephone company contracts for supplies and construction services that would also be severely impacted by this legislation.

As the telephone companies curtailed or canceled the contracts with their suppliers the ripple effect would produce additional layoffs and unemployment.

Third, public utility companies like the telephone companies must continually expand and modernize to keep pace in the highly competitive telecommunications industry.

Part of this modernization is the extensive training of their employees that our union members must undergo on a continuing basis to keep their high productivity standards.

Major layoffs in this highly trained work force could seriously affect the quality of service provided by Pacific Telephone and General of California.

And, finally, employee morale would be seriously affected. Our members have a long tradition of pride in giving good service. That is what makes the American telephone system the best in the world. To be deprived of the resources needed to give good service would be very demoralizing to CWA members.

Before I conclude my testimony, I would like to bring to your attention another area in which H.R. 1524 will have a very definite impact.

As you may be aware, sometime in 1984 the American Telephone & Telegraph Co. will divest itself of its 22 Bell operating companies—Pacific Telephone included—under a consent agreement reached with the Department of Justice.

It is of a primary concern to CWA that when this divestiture occurs, Pacific Telephone be in the soundest financial position pos-

sible, not only to the benefit of its employees, but also to the benefit of its customers.

I ask you, what kind of a future will Pacific Telephone have with a $3 billion tax liability hanging over its head as this divestiture goes into place?

For all of these reasons, I ask that you favorably report H.R. 1524.

I thank you for your time and your consideration.

Mr. MATSUI. Thank you, Mr. Watts.

Mr. Topper.

STATEMENT OF BERNARD C. TOPPER, JR., VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL, TAXES, GTE SERVICE CORP., GENERAL TELEPHONE & ELECTRONICS CORP.

Mr. TOPPER. Thank you, Mr. Chairman.

My name is Bernard C. Topper, Jr. I am vice president and associate general counsel, taxes of GTE Service Corp.

I am accompanied today by Dave Anderson, president of General Telephone Co. of California, GTE's largest telephone company.

Needless to say, GTE and its telephone companies, which comprise the second largest telephone system in the United States, are vitally interested in the action you will take on the two bills before you today.

I have submitted written testimony and if I may, I will restrict my comments to H.R. 1524.

This bill is designed to provide equitable relief to three California utilities that find themselves in situations almost beyond imagination. General of California is one of the affected utilities.

These utilities have been required to flow through to their customers a part of the tax benefits of accelerated depreciation and the investment tax credit. This action has been imposed on them by the California governmental authorities.

The IRS deems this flow-through to violate the code, to be contrary to the intent of Congress and, through no fault of the utilities, to disqualify them retroactively from taking the tax benefits.

The end results are assessments against the utilities of staggering amounts of back taxes. General's potential liability for the back taxes and interest was $495 million as of the end of last year, an amount equal to 45 percent of its equity capital.

Today, General's only option is to contest the tax assessment in the courts. The sad fact is that litigation, regardless of outcome, will produce only losers.

If the utilities succeed in their challenge, there is little doubt that the result will be an increased flow-through of the tax benefits not only in California but in other States as well. This would undermine the intent of Congress in enacting the normalization rules and deprive utilities of badly needed capital.

If, on the other hand, the utilities are unsuccessful, they will be penalized and required to pay the almost unbelievably large back tax liabilities. This would dangerously decapitalize the utilities and could destroy their ability to provide service.

The solution lies in enacting H.R. 1524. The bill would clarify the normalization rules to prevent any future misunderstandings in

California and elsewhere and would provide a transitional rule that forgives the potential back tax liabilities that not even the IRS wants to collect.

The bill is not new. An identical bill received a very favorable response in the last Congress, passing this committee and the full House on voice votes. I believe you will conclude, as did this committee last time, that the bill is noncontroversial and deserves your support.

The position of the affected utilities presents a compelling case for relief. Where a State's authorities have interpreted some of the code's most complicated provisions to permit an unintended result, basic fairness requires that the provisions be clarified first and only then should a tax be exacted for noncompliance.

Your action to provide that relief is particularly appropriate in response to what I believe to be conciliatory moves taken by the California authorities to resolve this dispute.

The California Public Utilities Commission has issued orders permitting General's rates to be collected on a full normalization basis for the time being.

The California Supreme Court, for its part, has denied the appeals seeking to overturn the Commission's full normalization orders.

I respectfully suggest that it is now time for Congress to take the final step in resolving the dispute by enacting H.R. 1524.

So far, the problem exists only in California. But, as matters now stand, there is no assurance the problem will end there.

Enacting the bill would provide that assurance. It would also put an end to the California tragedy and resolve the future viability of the affected utilities. They can then get on with their business of serving the public.

If I could I would like to conclude by mentioning a couple of reasons why we think that enacting this bill will make it clear not only to California but to other States and their regulatory commissions as well that normalization is the only way to go.

We think that by enacting the bill, making clear the rules for normalization, will provide a strong and clear message to all utility commissions throughout the country that Congress is serious about normalization and that these rules must be respected.

We don't believe that enacting this bill and providing the retroactive forgiveness for some of the utilities will provide incentives to other commissions.

We think that Congress is saying if it passes this bill that there was a provision in the Code that, at least as far as the California Commission believed, had some ambiguity in it. Congress, in taking the steps to make perfectly clear the meaning of normalization, is saying only that we are now speaking and saying normalization is the only way.

This is precisely what Congress means by normalization. We think it would be clear that normalization must be respected by all in the future.

Thank you, Mr. Chairman.

Mr. MATSUI. Thank you, Mr. Topper.

[The prepared statement follows:]

STATEMENT OF BERNARD C. TOPPER, JR., VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL, TAXES OF GTE SERVICE CORP.

Mr. Chairman and Members of the Committee:

My name is Bernard C. Topper, Jr. I am Vice President and Associate General Counsel - Taxes of GTE Service Corporation, a subsidiary of General Telephone & Electronics Corporation, known as GTE. GTE is the parent company of a group of companies that provide telephone service, other forms of communication service and manufacture electronic and electrical equipment and products. It is the second largest telephone system in the U.S., providing service to approximately 16.1 million telephones.

It is my pleasure to appear before you today and testify on two proposed bills, H.R. 1524 and H.R. 6503. H.R. 1524 would correct a serious inequity having a very detrimental impact on GTE and its telephone subsidiary in California. H.R. 6503 would impose a serious inequity on all of GTE's telephone subsidiaries and all other utilities. Needless to say, GTE is vitally interested in the action you will take on these bills. I would like to discuss H.R. 1524 first.

H.R. 1524

INTRODUCTION

H.R. 1524 addresses a serious inequity caused by conflicting federal and state positions concerning the proper method of accounting for the tax benefits of accelerated depreciation and the investment tax credit.

Congress carefully fashioned sections 46(f) and 167(l) of the Internal Revenue Code to require "normalization" of the tax benefits to ensure that the benefits have their intended effect of providing an incentive for capital investment. The governmental authorities in one state, namely the California Supreme Court and the California Public Utilities Commission, have seen fit to interpret those provisions to achieve an increased allocation of the tax benefits to present customers at the expense of the affected utilities and future customers, and in violation of the generally understood meaning of the statutory normalization provisions.

As a result, the eligibility of certain California utilities for the tax benefits has been placed in jeopardy, exposing them to staggering amounts of back tax liability. If these amounts were to be paid, they would dangerously decapitalize the utilities and have the potential to destroy their ability to provide service to the public. General Telephone Company of California ("General"), GTE's largest telephone subsidiary, is one of the affected utilities. It serves 4.1 million telephones and has a total investment of $3.4 billion in telephone plant and equipment in the State of California.

The provisions contained in H.R. 1524 are not new. An identical bill received a favorable response in the last Congress, failing to be enacted when the Senate adjourned before the bill could be brought to the Senate floor for a vote. Undoubtedly, this favorable response reflected Congress'

recognition of the terribly inequitable situation in which General and the other affected utilities find themselves.

H.R. 1524's PRIOR HISTORY

During the last Congress, this Committee and the House Rules Committee reported out an identical bill (H.R. 6806) by voice votes. The bill passed the full House on September 24, 1980, also by a voice vote.

Subsequently, the predecessor bill was reported out, without objection, by the Senate Finance Committee. It was brought to the Senate floor under a unanimous consent procedure on the final day of the last Congress, but failed to pass when one senator objected to the bill for reasons totally unrelated to its merits.

In addition, in section 209(d)(4) of the Economic Recovery Tax Act of 1981 ("ERTA"), this Congress has stated its intent to address the matter of normalization in the near future, granting the Treasury Department only interim authority to issue regulations "until Congress acts further." I understand that Congress limited the Treasury's authority in anticipation of prompt legislative action in this area, as would be accomplished by enacting H.R. 1524.

In view of this background, I would strongly hope that this Committee and Congress will see their way clear to give their prompt approval to H.R. 1524. By this action, the future viability of General would be resolved and it can get on with its business of serving the public.

NORMALIZATION REQUIREMENTS

The tax benefits of accelerated depreciation and the investment tax credit were expressly designed by Congress to provide an incentive for capital investment. If, however, the tax benefits are not available to a public utility because a regulatory commission, in setting rates, requires that the benefits be passed on (or "flowed-through") to customers in the form of current rate reductions, the stimulus for capital investment is lost.

A utility is normally entitled to recover its cost of providing service to the public. Since one component of a utility's cost of service is its tax expense, absent a statutory restraint, a regulatory commission could flow-through the tax benefits to present customers in the form of current rate reductions by computing a utility's tax expense net of the two tax benefits. This is a form of ratemaking known as "flow-through ratemaking."

In 1969, Congress took steps to put an end to what it viewed as an undesirable trend to flow-through ratemaking by enacting the normalization requirements for accelerated depreciation. The requirements provided, as a condition of eligibility, that the tax deferrals resulting from accelerated depreciation be "normalized," i.e., set up as a reserve rather than used currently to reduce rates, as is done under flow-through ratemaking. This rule carefully balances the interests of all concerned -- it provides capital to a utility

by permitting it to use the tax savings from accelerated depreciation and it provides a benefit to the utility's customers in the form of lower rates since the deferred tax reserve is typically excluded from the rate base on which a utility is permitted to earn a return.

In reinstating the investment tax credit in 1971, Congress again expressed its displeasure with flow-through ratemaking and required, also as a condition of eligibility, that the credit be "normalized" to prevent the immediate flow-through of the tax benefit to a utility's customers. In enacting these requirements, Congress again balanced the interests of the utilities, and present and future customers.

More recently, the current Congress has very clearly indicated its continuing support for the normalization requirements. In enacting the ACRS capital recovery and the investment tax credit provisions in ERTA, Congress explicitly required that those tax benefits will not be available to any utility unless the benefits are normalized. This action represents an even stronger Congressional commitment to normalization. In the past, when Congress had taken steps to require normalization, it had "grandfathered" some flow-through ratemaking, permitting the continued use of flow-through ratemaking in certain situations where utilities were already subject to such ratemaking.* Under ERTA, unlike prior law,

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*These prior rules that permitted the continued use of flow-through ratemaking in certain circumstances had no application to General.

there are no grandfather provisions and no exceptions. For all utilities, normalization is the only acceptable method. Otherwise, the tax benefits will not be available.

I submit that, as Congress has continually recognized, there can be no question about the wisdom of the normalization requirements. To accomplish the Congressional intent of stimulating capital investment, these requirements are unquestionably necessary. Flow-through ratemaking is completely contrary to this intent.

Prior representatives of the Treasury Department have reached the same conclusions, including then Deputy Assistant Secretary of the Treasury Emil Sunley in testimony before the Oversight Subcommittee of the Ways and Means Committee in 1979. Thereafter, then Deputy Assistant Secretary Daniel Halperin reaffirmed these conclusions in his testimony on H.R. 6806 -- H.R. 1524's identical predecessor -- before the Ways and Means Committee on April 15, 1980, and before a Subcommittee of the Senate Committee on Finance on November 19, 1980.

The action taken by the Federal Communications Commission in its Report and Order, released on December 5, 1980, in Docket No. 20188 provides further support for these conclusions. The FCC substantially revised its depreciation practices to improve the capital recovery of telephone companies for the avowed purpose of encouraging increased capital investment, with the expectation that the new

investments will result in benefits to customers that far outweigh any initial increases in telephone rates.

Finally, the Federal Energy Regulatory Commission has recently stated its strong support for the concept of normalization. In Orders Nos. 144 (May 14, 1981) and 144-A (Feb. 22, 1982), the Commission implemented a policy that requires the normalization of additional book and tax timing differences not covered under the normalization provisions of the Internal Revenue Code.

THE UNIQUENESS OF THE NORMALIZATION REQUIREMENTS

While the normalization requirements are necessary to accomplish the intent of Congress, they do create a unique situation in which a utility's eligibility for the tax benefits is dependent not upon any action taken by it, but rather upon action taken by a third party, i.e., the action taken by a regulatory commission in setting rates. Typically, a person takes an action and is responsible for the consequences. Here, a regulatory commission can take an action, but the consequences fall upon a utility. It is this separation of action from consequences which has placed General in a terribly unfair position.

The California Public Utilities Commission, responding to actions taken by the California Supreme Court, adopted newly devised, partial flow-through methods designed to flow-through a portion of General's tax benefits to current customers in

violation of the generally understood meaning ascribed to the normalization requirements. The California authorities took these actions notwithstanding the fact that General took every conceivable action to convince them to the contrary. As a consequence, ironic as it may be, General -- and not the California Commission or Supreme Court -- has incurred a substantial potential liability for back taxes (and interest) of $495 million as of December 31, 1981.

In addition, on the assumption that the partial flow-through methods satisfy the normalization requirements, the Commission ordered General to refund to customers approximately $110 million of the tax benefits (including interest) in June 1980 and June 1981. Hence, if General is ultimately found not to satisfy the normalization requirements as a result of the actions taken by the California governmental authorities, General will be required, in effect, to return the tax benefits to the federal government by paying the back tax liability, even though it has already paid a portion of the same benefits to its customers.

The cumulative effect of all this is almost beyond imagination. Surely, the members of this Committee will agree that General has been placed in a terribly unfair and inequitable position. The title of an article which appeared in the September 10, 1979 issue of Fortune magazine aptly describes General's plight -- The Tax Break That Turned Into a Nightmare. I submit that General's situation, caused by no action on its part, presents a compelling case for relief.

This is the reason for H.R. 1524. It is designed to prevent a similar problem from arising in California and elsewhere in the future and to provide relief to General (and others similarly situated) during a limited transitional period ending on March 1, 1980.

HOW GENERAL'S SITUATION AROSE

Following the enactment in 1969 of the normalization requirements pertaining to accelerated depreciation, General elected to use accelerated depreciation for federal income tax purposes. The California Commission issued decisions that, for the period beginning January 1, 1970, General and another California telephone company could use accelerated depreciation and could normalize their tax expense in compliance with the generally understood meaning of the normalization requirements. Subsequently, the California Supreme Court in 1971 annulled the Commission's ruling on procedural grounds, stating that the Commission had erred in failing to at least consider alternatives to normalization that would be more favorable to current customers and remanded the matter to the Commission for it to consider such alternatives.

In 1974, three years later, and after a rehearing before the California Commission, the Commission again decided that General could use a full normalization method in fixing rates. At the same time, in deciding a separate rate increase application, the Commission reaffirmed that position and adopted a ratable cost-of-service reduction for the investment

tax credit in compliance with the generally understood normalization requirements in section 46(f)(2) of the Code. Late in 1975, the California Supreme Court annulled the 1974 Commission orders with respect to the treatment of accelerated depreciation and the investment tax credit, remanding once more for consideration of alternatives to normalization, on the one hand, and flow-through, on the other.

As a result, in 1977, the California Commission issued an order in which it interpreted the Internal Revenue Code as permitting a change from the normalization procedures theretofore used, which clearly satisfied the normalization requirements in the Code and preserved eligibility, to newly devised, partial flow-through methods of setting rates. Under these new methods, the Commission achieved an additional flow-through of General's tax benefits to current customers, requiring it to reduce rates for the future and make refunds, going back to 1971. The Internal Revenue Service has ruled that the Commission's partial flow-through methods embodied in the 1977 order do not meet the statutory standards for eligibility.*

On November 8, 1977, the Commission granted a stay of the 1977 order pending judicial review. General, on December 7, 1977, appealed the order to the California Supreme Court. On July 13, 1978, the California Supreme Court denied the appeal.

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*Private IRS letter rulings nos. 7845018 (August 9, 1978) and 7836048 (June 9, 1978).

General then petitioned the United States Supreme Court, requesting review of the California Supreme Court's action. On December 11, 1978, the United States Supreme Court denied review, despite the urging of the Solicitor General of the United States. The Solicitor General stated to the Court that the California Commission's order caused General to lose its eligibility for accelerated depreciation and the investment tax credit. On January 5, 1979, General filed a petition for rehearing, which the high court denied on February 21, 1979.

Following the denial of review by the United States Supreme Court, the Commission, on March 14, 1979, ordered the filing of a refund plan and a reduced tariff, as required by the Commission's 1977 order. The United States District Court for the Central District of California subsequently denied a request by General for a preliminary injunction that would have stayed the Commission's order, which denial was affirmed by the United States Court of Appeals for the Ninth Circuit on July 18, 1979. An appeal from the latter ruling was denied by the United States Supreme Court.

Having exhausted all possible appeals, General filed a refund plan and a reduced tariff, the Commission held hearings with respect thereto and, on February 13, 1980, the Commission ordered refunds of $110 million as a result of its 1977 order.

THE URGENT NEED FOR LEGISLATION

As of December 31, 1981, General's potential federal income tax liability is a staggering $495 million and equals

approximately 45 percent of its common stock equity. The mere existence of this potential liability already presents difficult financial problems to General. Its outside auditors have required General to restate its financial statements to reflect the potential loss of eligibility for the tax benefits and, as a result, General's financial picture looks bleak. In late 1979 and, again, in March 1981, Standard & Poor's has downgraded its ratings for General's securities. These downgradings in ratings lead not only to increased interest costs in any financing at a time when interest rates are already at extremely high levels, but may also substantially limit the amount of potential funds available to General.

The problem is exacerbated by the demand for communications services in California which continues at unprecedented levels and requires continuing, enormous capital expenditures. General projects capital expenditures of some $4 billion for the 1980-1984 five-year period, an increase of approximately 120 percent over the preceding five-year period. With the financial cloud hanging over General's head, it is uncertain whether the necessary external funds can be found to meet this demand. If somehow the funds can be found, it will only be at an increased cost borne by the customers.

If you do not act favorably on this bill, the only available means for resolving this dispute will be tax litigation brought in the Tax Court, a district court or the Court of Claims. The resolution of the tax litigation can be

expected to take many years. During these years, of course, the existence of the potential liability for back taxes will have grave effects on General and on its customers.

If the California Commission's partial flow-through methods are held not to satisfy the Code's normalization requirements by a final court determination, the determination will, of course, provide no relief to General and may be the death-knell for General and telephone service provided by it in California.

If, on the other hand, it is determined that the partial flow-through methods satisfy the normalization requirements and the back taxes are, therefore, not payable, there is little doubt that other regulatory commissions throughout the country will be encouraged to flow-through all or a part of the tax benefits. This is especially true today since, under ERTA, regulatory commissions will be setting rates for many utilities which, for the first time, are required to normalize their tax benefits if they are to continue to be eligible for the benefits. The use of flow-through methods by regulatory commissions would clearly undermine the avowed purpose of Congress in enacting the normalization requirements, i.e., the intention to provide an incentive for capital investment to the highly capital-intensive utility industry.

Surely, allowing this controversy to be determined by litigation would be a mistake -- neither of the possible results

of litigation is desirable. Only legislation can provide the necessary equitable relief to General while, at the same time, assuring that the Code's normalization requirements will accomplish their desired objective.

THE NECESSARY RELIEF

I believe you will agree that the situation in which General finds itself is unconscionable. It is caught in the middle between conflicting federal and state positions. General is no mere bystander -- at stake is some $495 million as of December 31, 1981.

H.R. 1524 would provide the equitable relief so desperately needed. It provides, in effect, that the partial flow-through methods adopted by the California Commission will not retroactively result in the loss of the tax benefits to General (and others similarly situated). The bill limits this relief, as it properly should, to as short a period of time as is possible, namely, to a period ending on March 1, 1980. In other words, from that date forward, the Commission must adhere to full normalization of the tax benefits or General will not be eligible for any post-March 1, 1980 tax benefits. This, I believe, would be clear to all.

This portion of H.R. 1524 is, thus, a very limited response designed to overcome a particularly egregious problem. It goes only as far as necessary to provide a solution -- and no further.

THE BILL ALSO MAKES CHANGES TO PREVENT FUTURE MISUNDERSTANDINGS

H.R. 1524 would amend the normalization requirements in sections 46(f) and 167(l) of the Code to prevent any future misunderstandings of the requirements.* It adds specific language to make clear that the California Commission's partial flow-through methods do not satisfy those requirements. The bill also grants to the Secretary of the Treasury the explicit power to adopt regulations prescribing other procedures and adjustments that are inconsistent with the normalization requirements. I believe this accomplishes two very important objectives: first, it provides a clear signal to all that the federal government is serious about requiring adherence to full normalization; and secondly, it places the Treasury Department in a much better position to issue binding regulations explaining the meaning to be ascribed to the normalization requirements.

I believe that the changes made by the bill to sections 46(f) and 167(l) of the Code would provide a complete answer to any concern that the relief provided to General (and others similarly situated) in the bill may encourage other regulatory commissions to stray from strict adherence to full normalization, with the expectation that Congress will enact a

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*Since the introduction of H.R. 1524, ERTA has been enacted, with new normalization provisions governing ACRS capital recovery. H.R. 1524 should be revised so that its rules will apply to these provisions as well.

similar relief bill for them. The general changes made by H.R. 1524 clearly, and quite forcibly, indicate just the contrary. Congress, in H.R. 1524, is reaffirming its support for full normalization. The message from Congress would be perfectly clear -- full normalization is the only alternative. This will be understood by the California authorities and other state courts and regulatory commissions.

Even beyond this, it seems a simple matter to make clear in the legislative history accompanying H.R. 1524 that no one should expect any further relief for failure to comply with the requirements of full normalization. Compelling equitable grounds exist for the relief afforded to General in H.R. 1524. After Congress reaffirms its support for full normalization in H.R. 1524 and makes the requirements more explicit, there can be no equitable justification for a state court or regulatory commission to adopt any flow-through method, partial or otherwise.

The Report of the Ways and Means Committee accompanying H.R. 6806 -- H.R. 1524's identical predecessor -- dated July 30, 1980, accomplishes this result. It states (at page 11) that the relief provided by the bill "is designed to meet a specific, one-time problem which has arisen as a result of a misapplication of the normalization requirements ..." and that the Ways and Means Committee "does not intend that the provision of relief in this instance should be regarded as a precedent for similar relief in subsequent incidents."

THE APPROPRIATENESS OF THE RELIEF

I believe that the members of this Committee will agree that the position in which General finds itself presents a compelling equitable case for the relief provided in H. R. 1524, i.e., the elimination of the potential back tax liability. Simply stated, General is caught between conflicting federal and state interpretations of the normalization rules. The California governmental authorities have required General to use newly devised, partial flow-through methods of normalization. The use of these methods is not of General's choosing. But it is General and its customers -- not the California authorities -- that would be required to pay the back taxes.

Where a state's governmental authorities have interpreted some of the Code's most complicated provisions to permit a result presumably unintended by Congress, basic fairness requires that the provisions first be clarified and only thereafter should a tax be enacted for noncompliance. In addition, the relief in H.R. 1524 is fair vis-à-vis other utilities. It does not treat General any more favorably than other utilities which normalize their tax benefits.

In any dispute, it is always attractive to seek a fair compromise. H.R. 1524 represents such a compromise. In forgiving the back taxes, the bill accepts the partial flow-through methods of the Califonia authorities for the period prior to March 1, 1980, but requires, as it must, that

after that date rates be established on the basis of full normalization if the tax benefits are to be available.

I submit that this compromise is particularly appropriate in the present circumstances. The California Supreme Court and Commission have made what I believe to be conciliatory moves to resolving the dispute. Since mid-February 1980, the Commission has issued orders permitting General's rates to be collected on a full normalization basis, subject to a possible refund down the road if the issue is not resolved in a manner that effectively precludes a refund. Thereafter, the California Supreme Court, for its part, denied petitions to review the California Commission's full normalization order. It is now time for Congress to take the final step in resolving the dispute by enacting H.R. 1524. If it does, I am confident that rates will be set in California and in all other states on a full normalization basis, and General can get on with its business of serving the public.

H.R. 6503

INTRODUCTION

I would like to turn now to Section 1 of H.R. 6503. This portion of the bill would very significantly change the method by which utilities account for the investment tax credit. The change would deprive the highly capital-intensive utility industry of an incentive to make capital investments and vitiate the very purpose Congress sought in enacting the investment credit.

This Committee overwhelmingly rejected an identical provision in 1980 and I am confident you will also reject H.R. 6503.

H.R. 6503'S PROPOSED NORMALIZATION CHANGE

The existing provisions of section 46(f) of the Code permit a utility to elect one of two normalization methods for reflecting the investment tax credit for ratemaking purposes. Each of these options produces a sharing of the credit's benefits between a utility and its customers. The first option permits a regulatory commission, in setting rates, to deduct the credit from a utility's rate base to which a rate of return is applied, but the commission may not also reduce a utility's cost of service. When the rate base is reduced, the effect is to reduce the return allowed to a utility on its assets devoted to public service and, thereby, lower its rates. The second option, the option elected by the GTE telephone subsidiaries and most other utilities, permits a regulatory commission to flow-through the tax benefits of the credit to customers as a reduction in rates, but only ratably over the life of the assets rather than immediately in the year the credit is realized. Under this option, a utility's rate base may not be reduced to reflect the unamortized investment tax credit.

H.R. 6503 would combine these two options and permit a regulatory commission to reduce a utility's rate base to reflect the credit and flow-through the benefits of the credit to a utility's customers as rate reductions over the life of the assets.

THE PROPOSED CHANGE WOULD UNDERCUT CONGRESS' PURPOSE IN ENACTING THE CREDIT

The investment tax credit was first enacted in 1962 as a device to stimulate additional investments by increasing "... the expected profit from their use."* (Emphasis added.) The issue raised by the proposed change involves the manner by which a utility accounts for the credit to ensure that the underlying Congressional purpose of stimulating investments through increased profitability is satisfied. This issue has been considered several times before by Congress, as recently as just last year.

The investment tax credit was suspended in 1969 and subsequently reinstated in 1971. As a part of such reinstatement, Congress adopted the present normalization provisions in section 46(f). In so doing, Congress explicitly considered the balancing of the benefits of the credit between a utility and its customers to ensure that the credit would fulfill its intended purpose of stimulating investment, while also allowing a utility's customers to receive a portion of the benefits. The normalization rules accomplish Congress' dual objectives: under the option selected by most utilities, they permit the investment credit's benefits to be flowed-through to customers in the form of rate reductions over the lives of the property involved; and they provide a stimulus for capital investment by permitting a utility to earn a return

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*H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962), p. 8.

on its rate base without any reduction for the unamortized credit.

When the investment tax credit rate was increased from 4 percent to 10 percent for public utilities in 1975, Congress reaffirmed its support for the existing two normalization methods of reflecting the credit contained in section 46(f). It specifically provided that even those utilities allowed to flow-through the benefits immediately in 1971 (certain utilities which historically flowed-through the benefits were allowed to continue doing so) would be required to use one of the two existing methods for the 6 percent increase in the credit, unless they expressly elected immediate flow-through.

In 1980, this Committee considered H.R. 3165, a bill introduced by Congressman Stark. That bill's provisions are identical to section 1 of the present H.R. 6503. This Committee rejected that bill by a vote of 28 to 6. Even more recently, the current Administration included a similar provision in its original tax cut proposal last year (H.R. 2400 and S. 633). It subsequently deleted the provision in later proposals and ERTA, as enacted by Congress, contained no such provision.

Thus, over a period of many years, Congress has considered the proper treatment of the investment tax credit of a utility and has consistently reached the conclusion that the treatment provided in present section 46(f) is the proper one.

This is not surprising. If the proposed change were to become law, thereby denying a utility the ability to earn a return on the portion of its rate base attributable to the investment credit, the credit would not provide the stimulus to make an investment intended by Congress in enacting the credit.

THE PROPOSED CHANGE WOULD DISCRIMINATE AGAINST UTILITIES

H.R. 6503's proposed change to the normalization rules would also discriminate against utilities. When Congress increased the investment tax credit to 10 percent for a utility in 1975 in order to place it on an equal footing with other businesses, it did so in recognition of the fact that a lower investment tax credit rate for utilities "discriminates against investment in utilities and impedes such investment at a time when the public utilities need large amounts of capital to build up their capacity to meet the growth in demand for their services."*

H.R. 6503 would impose a new form of discrimination by depriving utilities -- and only utilities -- of the ability to earn a return on the unamortized credit. This is especially ironic since it is only the utility industry which has a proven track record of sharing the benefits of the credit with its customers. This proposed change -- and its attendant discrimination -- would disturb the balance struck by Congress in 1975 between utilities and other businesses and make it even

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*H.R. Rep. No. 94-19, 94th Cong., 1st Sess., p. 12 (1975).

more difficult than it is today for utilities to compete for available capital.

H.R. 6503 RUNS COUNTER TO OUR NATION'S ECONOMIC RECOVERY PROGRAM

It is generally recognized today that increasing our nation's productivity is essential if we are to revitalize the U.S. economy, increase the competitiveness of U.S. companies abroad and improve our nation's overall standard of living. Increased capital recovery is a key ingredient to increasing our nation's productivity.

It is difficult to think of an industry in which improved capital recovery can provide more productivity benefits than the telephone industry. Its rapidly advancing technology offers an array of opportunities to improve productivity.

To embrace this new technology, we in the telephone industry must have sufficient capital available to us. Continuing the present method of accounting for the tax credit would provide us with some of the additional capital we so desperately need.

One example of the way technology improves productivity in the telephone industry can be found in the basic telephone switching system. The replacement of an electromechanical switch with an analog electronic switch can reduce maintenance costs by as much as 60 percent and floorspace requirements by 40 percent. A digital electronic switch offers additional reductions of 35 percent for maintenance and 60 percent for floorspace. The overall savings for digital electronics as

compared to electromechanical switching amount to about three-quarters of both the maintenance and floorspace costs.

The new telephone technology also offers an array of new services which will improve the productivity of other U.S. industries. The list is almost endless -- let me list but a few: electronic mail; video conferencing; data base access; electronic funds transfer; credit verification; and energy control and conservation. I'm sure you have all seen articles about the office and home of the future.

In today's economic atmosphere, it would be a tragedy to discriminate against the telephone industry by depriving telephone companies of badly needed capital and deny our economy the full opportunity for significant productivity gains -- one of the prime objectives sought in the nation's current Economic Recovery Program.

If H.R. 6503's proposed normalization change were to be adopted, a utility would not be permitted to earn a return on a portion of its rate base. As a result, its revenues will decrease. This, in turn, will decrease the amount of federal income taxes paid by a utility, causing a reduction in revenues to the federal government.

Moreover, if utilities are to replace this loss of revenues and capital, they will be forced to turn to the capital markets to an even greater extent, increasing the already considerable pressure on those markets.

All these effects of the bill could not come at a worse time. They run completely counter to our nation's Economic Recovery Program and its current efforts to increase productivity, reduce the federal budget deficit and decrease interest rates.

For these reasons, I am confident that this Committee will reject H.R. 6503.

Mr. MATSUI. Mr. Curtis.

STATEMENT OF JOHN J. CURTIS, JR., DIRECTOR OF TAXES, PACIFIC LIGHTING CORP., ON BEHALF OF PACIFIC LIGHTING CORP. AND SOUTHERN CALIFORNIA GAS CO.

Mr. CURTIS. Mr. Chairman, I am testifying today on behalf of Pacific Lighting Corp. and its principal subsidiary, Southern California Gas Co., which is the Nation's largest gas distribution company in terms of number of customers served.

We want to thank this committee and its staff for holding these hearings and permitting me to comment.

We strongly favor H.R. 1524 and cannot support H.R. 6503. I would like for my written comments to be entered into the record and I would like to emphasize essentially two important points.

The issue was raised earlier today of whether or not the appropriate way to establish congressional intent regarding normalization and its relationship to the problems in California would be litigation, court tests.

I think that that is the most undesirable method of resolving the conflict because litigation would go on for many years and it would cost both the taxpayers and the ratepayers very large sums of money just to conduct the litigation.

If the utility lost in court it would be deprived of the tax benefits Congress intended. It would also probably be unable to recover its taxes in rates or would have very great difficulty in recovering these taxes in rates.

Even if the utility ultimately prevailed, the protracted uncertainty over its tax liability would undoubtedly adversely affect its financial standing causing higher debt costs and ultimately higher rates.

I think H.R. 1524 is designed to void these terrible consequences, a no-win situation, and to rectify the unfair tax position that the three affected California utilities find themselves in.

I think the second point I would like to stress orally is that H.R. 1524 really has no adverse impact on Federal revenues. Congress has always intended that public utilities receive these tax benefits. It was never contemplated that these benefits will be lost due to technical difficulties.

The passage of H.R. 1524 will have no adverse impact on the Federal revenues and Congress original policy intent will be implemented.

I would like just to conclude by saying that time is of the essence. We urge Congress to consider and enact H.R. 1524 as quickly as possible.

[The prepared statement follows:]

STATEMENT OF JOHN J. CURTIS, DIRECTOR OF TAXES OF PACIFIC LIGHTING CORP., ON BEHALF OF PACIFIC LIGHTING CORP. AND SOUTHERN CALIFORNIA GAS CO.

Mr. Chairman, I am testifying today on behalf of Pacific Lighting Corporation and its principal subsidiary, Southern California Gas Company, which is the nation's largest gas distribution company in terms of number of customers served. We want to thank this committee and its staff for holding these hearings and permitting me to comment. We strongly favor H.R. 1524 while we do not support H.R. 6503.

Passage of H.R. 1524 will assure that public utilities can retain two very important economic incentives provided by Congress, accelerated depreciation (both under

prior law and under the accelerated cost recovery system) as well as investment tax credit.

To be eligible, Congress has required that utlities account for these benefits both in rates and on their books using specific accounting methods contained in the law and explained in Treasury Regulations. Failure of the utility or its regulatory commission to conform to these accounting methods results in forfeiture of the tax benefits.

Several years ago, the California Public Utilities Commission ordered two California telephone companies to account for accelerated depreciation and investment tax credit using Commission created variations to the restrictive accounting methods found in the federal law and regulations. The Commission believed that its methods conformed to the requirements in the law. However, in private rulings the Internal Revenue Service determined otherwise and charged the telephone companies with over one billion dollars in back taxes.

In 1976, Southern California Gas Company found itself in the middle of a similar dispute between the California Commission and the Internal Revenue Service concerning the ratable flowthrough requirements of the investment tax credit. This dispute is still lingering, and threatens Southern California Gas Company's eligibility for much of the Company's investment tax credit.

Specifically, in 1975 SoCal Gas elected, pursuant to Section 46(f)(2), ratable flowthrough for the additional investment tax credit provided by the Tax Reduction Act of 1975. A taxpayer making such an election loses the credit if its regulatory agency requires it to flow through the credit in its rates faster than ratably.

In 1976 the California PUC reduced SoCal's rate of return by .25 percent in an offset case and ordered refunds.

The California Commission concluded that its rate of return reduction would (and I quote) "best recognize SoCal's reduction of risk because of increased cash flow, increased interest coverage, and relieved financial requirements resulting from the Tax Reduction Act of 1975." (PUC Decision No. 86117, 7/13/76.)

The PUC also expressly concluded that its action did not result in faster than ratable flowthrough and thus would not cause SoCal to forfeit the additional ITC. The California Supreme Court affirmed the Commission's refund orders in 1979, roughly 31 months after the Commission's decision. As a result SoCal's rates were determined on the assumption that it was eligible for the additional ITC.

However, in a letter ruling to SoCal Gas, the IRS concluded, contrary to the California PUC and the California Supreme Court, that the PUC's action would cause SoCal to lose eligibility for the additional credit because it did result in faster than ratable flowthrough.

Consequently, SoCal now face the ominous possibility of losing the additional credit provided by Congress in 1975 while at the same time charging lower rates on the assumption that it is eligible for the additional credit.

Unfortunately, the PUC refund orders, the California Supreme Court Decision, and the IRS Rulings were issued prior to the publication of the Treasury Regulations interpreting Section 46(f). These regulations indicate what ratemaking practices will or will not cause a utility to lose the credit. The California Supreme Court modified its decision after the regulations were published to conclude that SoCal would still not lose eligibility for the additional credit. After this decision SoCal requested that the IRS revoke its earlier ruling and rule, as the California Supreme Court has concluded, that SoCal would not lose eligibility for the credit. The IRS was extremely reluctant to reconsider its conclusion and suspended its consideration of SoCal's request when the first legislation on this matter, H.R. 6806, was scheduled in 1980 for hearing before the House Ways and Means Committee. As of today the IRS consideration of SoCal's request is still in suspense.

We believe it would be unfair to SoCal, its ratepayers, and the PUC if SoCal lost the additional ITC for many years because California issued a rate of return adjustment in 1976 while the law was unclear and before interpretive regulations were published.

In our statement we have not addressed the specific problems of the two California telephone companies in detail because their past and present testimony contains a clear statement of their dilemma. While the telephone companies' problem is not exactly like SoCal's, both problems similarly arise essentially out of a controvrsy between the California's Commission and the Internal Revenue Service over the lawful and proper interpretation of federal tax law and regulations.

These controversies between the California Commission and the Internal Revenue Service create a very serious dilemma for the two California telephone companies and Southern California Gas Company as well as a potential dilemma for other utilities who may become involved in similar controversies.

Wherever a utility regulatory body issues an order which the Internal Revenue Service determines is not in conformity with the tax laws, the affected utility will be required to go to court to resolve the issue. The court battle will undoubtedly go on for several years and cost the taxpayers and the ratepayers large sums of money. Further, the tax liability of the utility can become chaotically unpredictable.

If the utility lost in court, it would be deprived of the tax benefits Congress intended for them to have, and, depending on state regulatory law, the utility could very well be unable to recover their tax losses in rates. Even if the utility ultimately prevailed, the protracted uncertainty over its tax liability would adversely affect its financial standing causing higher debt costs and ultimately higher rates.

Wherever such a situation is created, the utility is deprived of most, if not all, of these economic incentives provided by Congress in the tax law.

H.R. 1524 is designed to avoid these terrible consequences and to rectify the unfair tax position that the affected utilities find themselves in. H.R. 1524 clarifies in the tax law that the accounting methods ordered by the California Commission or any similar methods contemplated by other commissions do not conform to the accounting requirements which must be met by public utilities to claim accelerated depreciation, accelerated cost recovery or investment tax credit. Enactment of H.R. 1524 will help insure that public utilities throughout the country will not lose the economic incentives that Congress provided due to confusion or a misreading by regulatory bodies of the accounting requirements in the tax law. H.R. 1524 does this expressly for past problems, and by clearly dealing with this past confusion in precise new statutory language, it should prevent a recurrence in the future.

Most importantly, H.R. 1524 has no adverse impact on federal revenues. Congress has always intended that public utilities receive the tax benefits in question along with other industries. It was never contemplated that these benefits would be lost due to technical difficulties within the law. Passage of H.R. 1524 will mean that Congress' original intent and policy will be implemented.

For these reasons, we urge you to act favorably on H.R. 1524 as it is presently drafted and to do so as quickly as possible to remove the cloud that has been hanging over the affected companies.

As for H.R. 6503, we cannot support it. The congressional intent for the past 20 years behind providing investment tax credits has been to provide American companies, including utilities, with an incentive to modernize the Nation's productive facilities. Investment tax credits help companies, including utilities, finance essential new capital on which the general health of our economy and vitally needed new jobs are so dependent. H.R. 6503 is directly contrary to that congressional policy of the past 20 years. H.R. 6503 would require utilities that are now sharing the benefits of their investment tax credit with their ratepayers under one of two roughly equivalent formulas to double the amount of credit passthrough in rates by applying both formulas. This effectively destroys most, if not all, of the capital formation incentive for these utilities. At the same time, H.R. 6503 reduces the tax receipts of the U.S. Treasury. While we could never support H.R. 6503 in principle, we also believe that now is certainly not the time for Congress to reduce any capital formation benefit for utilities which simultaneously lowers revenue to the Treasury. H.R. 6503 does both.

Since other testimony presented here today discusses the reasons for opposition to H.R. 6503 in detail, we do not believe it is necessary to repeat these reasons. We concur generally with the other witnesses opposing H.R. 6503.

In conclusion, we urge you to act favorably on H.R. 1524 as quickly as possible. We also believe H.R. 6503 should not be enacted.

Mr. MATSUI. Mr. Conable?

Mr. CONABLE. I have no questions.

Mr. MATSUI. Mr. Stark?

Mr. STARK. Thank you, Mr. Chairman.

Mr. Dalenberg, Pacific Telephone is an efficiently run company, isn't it?

Mr. DALENBERG. Oh, I think so.

Mr. STARK. Of your 65,000 employees, how many would you feel you could dispense with today and maintain your current level of service?

Mr. DALENBERG. Well, we have about 112,000 employees.

Mr. STARK. But of the 65,000 under contract, communication workers, how many do you think you could let go tomorrow and maintain your present level of services?

Mr. DALENBERG. I would have no idea.

Mr. STARK. Do you think any?

Mr. DALENBERG. I have no idea. I am afraid as general counsel——

Mr. STARK. Say 10 percent? Wouldn't you say if it was a well-managed company, under the management philosophies of AT&T, it would be pretty hard to lay off any?

Mr. DALENBERG. If you take a theoretical model such as the gentleman who spoke to us immediately before this panel, a theoretical model that would say there is an exact number of employees that could be utilized at any one time, I don't think——

Mr. STARK. Are you aware of whether or not you pay much overtime?

Mr. DALENBERG. Oh, I am sure we do.

Mr. STARK. Mr. Watts, are you aware that last year at this time the communication workers were back here asking us to pass a law to prevent mandatory overtime as required, and that your average worker was putting in 52 hours a week at Pacific Telephone?

Mr. WATTS. Yes, I recall that we did that. As a matter of fact, we continually oppose overtime and think that the use of overtime generally speaking——

Mr. STARK. It really comes down to rather a surprise to me where you have got your average worker putting in 52 hours a week, coming back here and complaining about overtime, to suggest that there is a place for AT&T to lay off thousands of workers to become more cost effective.

Mr. WATTS. If you jump to a conclusion like that you have misread everything that we said before and everything that I am saying now.

Mr. STARK. You can't have it both ways, Mr. Watts.

Mr. WATTS. Neither can your question, going both directions, without any basis in fact for even asking it.

My answer to you, sir, is that if this bill is not passed, the likelihood is that there will be far less investment in California, not only by the Pacific Co., but by the General Co., and I suspect by the electric utility as well. And it will be the result of that lack of investment, the lack of keeping up with modern equipment, to be sure that you have first-class telephone service in California——

Mr. STARK. I thought you were talking to me about layoffs.

Mr. WATTS. That will result in layoffs. Everywhere that you have seen a terrific reduction in investment in our economy today, you have seen exactly what would occur here. Lay off after lay off after lay off as a result of lack of investment.

Mr. STARK. When we have had terrific tax advantages like in the steel industry, how many employees did they hire back?

Mr. WATTS. You won't find the result of that not happening has had anything to do with the tax advantage in the steel industry, sir. You will find that there are other economic——

Mr. STARK. Tax advantages didn't cure the problem, did they?

Mr. WATTS. No; they did not.

Mr. STARK. Nor will they for the communication workers. You and I both know that.

Mr. WATTS. To the contrary. I am absolutely convinced that if in fact——

Mr. STARK. Does your union have a contract with AT&T?

Mr. WATTS. We have a contract with the AT&T and the operating companies; yes.

Mr. STARK. When does it expire?

Mr. WATTS. August of 1983.

Mr. STARK. You think—you have work rules in there under which they can lay off your employees?

Mr. WATTS. Yes.

Mr. STARK. Do you think this bill would make any difference, any changes in those rules.

Mr. WATTS. Not in the rules, no; but in terms of layoffs, yes.

Mr. STARK. How long has it been since they have had a major layoff?

Mr. WATTS. There are major layoffs underway in AT&T at this time. Last Friday, for example, AT&T announced they were closing down a Western Electric distribution house in Pittsburgh, Pa. Over 300 employees have been laid off in Merrimac Valley.

Mr. STARK. How about Pacific Telephone?

Mr. WATTS. Pacific Telephone has in the past had surpluses. Fortunately, though, the West Coast until quite recently has been better off economically than most parts of the country.

Mr. STARK. We are talking about the West Coast in the bill, are we not?

Mr. WATTS. We are talking about the whole country as far as I am concerned because if you look one step further in terms of what has happened with the rules made by the California Commission, the rest of the country has tended to provide better and cheaper service for California than they were providing by themselves, just because of this kind of a tax situation. The taxes being paid by people in the rest of the country would, in fact, if this bill is not enacted, be subsidizing telephone and electrical service in California because the other State commissions are not doing what California did.

Mr. STARK. That isn't such a bad deal for those of us in California, is it?

Mr. WATTS. No, but I think you ought to be fair with the rest of us as well.

Mr. MATSUI. Mr. Duncan?

Mr. DUNCAN. No questions, Mr. Chairman.

Mr. MATSUI. Mr. Rousselot?

Mr. ROUSSELOT. Thank you, Mr. Chairman.

Mr. Watts, to elaborate a little further on your comments, I was most interested in your thought that unless H.R. 1524 is passed, that you could predict thousands of layoffs of telephone workers and resulting cutback in services. Could you elaborate? My colleague, Mr. Stark, I thought confused that point just a minute ago. Could you elaborate on that a little more?

Mr. WATTS. Our past experience in situations that are not directly comparable, but in which there has been a denial of rate relief, as an example by a public utility commission, has resulted in a re-

duction in capital investment by the companies involved, and direct layoffs of our people. Based upon that past experience I have every expectation that if in fact the companies are forced to find the funds in order to pay the taxes that would otherwise be called for if this bill is not enacted that they would in fact begin to reduce costs in order to make that recovery. Since there wouldn't be any likelihood, I believe, of the rate commission in California giving them that kind of relief, since it started this problem to begin with.

That being the case in my opinion, the lack of investment in additional capital building and modernization would result substantially in the layoff of employees of the companies involved.

Mr. ROUSSELOT. So that statement on your part is based on past experience in other areas?

Mr. WATTS. That is right.

Mr. ROUSSELOT. It is not just a guess on your part?

Mr. WATTS. That is correct.

Mr. ROUSSELOT. Could you supply for the record some instances where that has occurred.

Mr. WATTS. Yes, we can. One I am recalling at the moment I believe is Tennessee. But there are a number of such instances. I will be happy to provide them.

Mr. ROUSSELOT. I think that would be helpful to the committee, especially to those who are not very sure of the value of investment policy as it relates to taxes, and how that does affect jobs in many places in the country. I think we should know about that and be aware of it. It would be helpful if you would do that. We would appreciate it very much.

Would any of the members of the panel care to comment on Mr. Kiefer's statements? Obviously he is very pro-flow through in his statements. Would any of you care to comment on the statements that he made?

Mr. TOPPER. I would be glad to, Mr. Rousselot. I think once you admit, as I believe Dr. Kiefer did, that the purpose behind the investment tax credit was to decrease the cost of purchasing equipment, and thereby enhance profitability, I think it follows inexorably that, if you deny a utility the right to earn a return on a portion of its rate base financed by the credit, that you have taken from a utility the right or purpose sought in enacting the credit.

You have taken from the utility the ability to enhance profitability. So it seems to me that the change proposed by Dr. Kiefer, the so-called economic normalization and as reflected in H.R. 6503, really does run against the intent of Congress when it first enacted the credit.

Mr. ROUSSELOT. Well, that is what I thought. But I just wondered if any of you would like to comment further on that or submit for the record some additional material that would be helpful to us. We would like to have it.

Mr. TOPPER. I have in my written statement covered H.R. 6503 and made this point and some other points. I might also comment that it seems to me that now is not the time to enact H.R. 6503, because it will have two effects on the Federal Government. No. 1, if our revenues, utilities' revenues, are decreased, obviously, the tax receipts we pay to the Federal Government would be decreased.

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To the extent that we are able to turn to the capital markets to try and replace the capital that would be lost to us because of this proposed change, I think you would find that there would be an increased pressure on those capital markets, thereby, if anything, tending to drive up interest rates. So I would suspect that now is not a good time for economic normalization regardless of its justification or lack thereof.

Mr. DALENBERG. I would like to second everything Mr. Topper says, and also point out that even Mr. Kiefer notes that this would be a time when it is very awkward for the utilities to stand up to the extra rates that would be required if that legislation went into effect. At Pacific Telephone we have taken a look at that. It appears to us that over the next 5 years we would be forced to have a rate increase approaching $900 million.

Mr. ROUSSELOT. Rate increase?

Mr. DALENBERG. That is correct.

Mr. ROUSSELOT. $900 million?

Mr. DALENBERG. To cover them.

Mr. MATSUI. Will the gentleman yield?

Mr. ROUSSELOT. Sure.

Mr. MATSUI. Following up on Mr. Rousselot's comment, if H.R. 6503 is passed, are you rewarding the present generation of ratepayers at the expense of future generations of ratepayers; is that correct?

Mr. TOPPER. I think that is correct, Mr. Matsui.

Mr. MATSUI. Second, with respect to that, the overall cost depends upon the given interest rates in the bond market. For example, if we use today's bond market rates, it is likely that the overall cost to the ratepayers will be for any capital formation purposes greater than under the terms of H.R. 6503, if it is not passed; is that correct?

Mr. TOPPER. I think that is correct. Some numbers we have looked at would tend to indicate that it would not take many years. It might be in the neighborhood of 5 years before rates would be higher because of the economic normalization change.

Mr. MATSUI. Thank you. I yield back to the gentleman from California.

Mr. ROUSSELOT. My time has expired according to the red light.

Mr. MATSUI. I would like to call on Mr. Frenzel at this time.

Mr. FRENZEL. No questions.

Mr. MATSUI. Mr. Pickle?

Mr. PICKLE. No questions.

Mr. MATSUI. I would like to thank the four gentlemen on the panel for being here today.

Now we would like to call our last panel, Mr. Foley, Mr. McCollam, and Mr. McGrath.

Gentlemen, without objection your written testimony will be received for the record. At this time we would like to call on Mr. Foley to testify.

STATEMENT OF MICHAEL FOLEY, DIRECTOR OF FINANCIAL ANALYSIS, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. FOLEY. Good morning, Mr. Chairman, members of the committee. My name is Michael Foley. I am the director of financial analysis for the National Association of Regulatory Utility Commissioners, commonly known as the NARUC. At the outset I would like to state in the strongest possible language that NARUC fully endorses the concept which we believe is contained in both of the bills, which would clear up the longstanding tax dispute between the IRS and certain utilities regulated by the California PUC.

We fully recognize that failure to resolve this question this year could result in the collection of a multibillion dollar tax liability from the utilities involved which would, in turn, have a pernicious impact on the ability of these companies to adequately serve the consumers in the State of California. I think the truth of the matter is if we don't settle this question in this Congress, the ratepayers are going to be the real losers.

There is some language in H.R. 1524 that we do have some problems with, however. Sections 1 and 2 of the bill restate and make the language stronger, which preempts the States in matters of ratemaking. Specifically I am referring to sections 46(f) and 167(l) of the Internal Revenue Code which preempt State regulatory commissions in handling ratemaking questions. The bill even goes one step further in that it delegates to the Secretary of the Treasury the ability to write regulations which could actually make adjustments to rate cases which have been handed down by the State PUC's. For that reason we feel we must oppose the preemptive language contained in the bill.

There is also another question before the committee this morning. That is this whole thorny issue of the proper sharing of ITC benefits. The concept of economic normalization, as every member of this committee is painfully aware, is not a new concept. It has been around several years. In fact, I believe this committee has handled the question on three or four different occasions.

The Economic Recovery Tax Act submitted by Congressman Conable to this committee on behalf of the administration also contained the concept of economic normalization. We feel that the concept of economic normalization does reflect the legislative history of the investment tax credit and that it would preserve the sharing concept, as well as the stimulative impact that the ITC was intended to provide to the utility companies.

And if I might direct your attention to the top of page 6 of my prepared statement, utility companies have been coming in before this committee and before the Senate Finance Committee and arguing that economic normalization would vitiate the purpose of the investment tax credit. They argue that it would end the sharing of the ITC. They argue that it would give all the benefits to the ratepayers, and none to the stockholders. I suggest that if utility companies should come in before this committee and try to make that argument, they ought to be put to a very simple question.

If the regulators' hands were untied in these matters, which is, of course, what we would prefer, and if the regulators had full dis-

cretion in setting accounting policy, which would the utility companies prefer? Full flowthrough which admittedly would give all the benefits to the ratepayers, or would they prefer economic normalization?

I submit that the utility companies would be charging off to the State PUC's and making my arguments and they would be making Dr. Kiefer's arguments in favor of economic normalization. They would do so because they recognize economic normalization does preserve a sharing of ITC benefits. They further recognize economic normalization does preserve the stimulative impact of the investment tax credit. These are the key points Dr. Kiefer has shown in his research that is published in the Journal of Business. To date I have not seen one rebuttal of Dr. Kiefer's research. Instead they make these specious arguments that economic normalization is going to give it all away to the ratepayers, which simply cannot be supported.

For that reason we feel we are going to support H.R. 6503 and because of the preemptive language in H.R. 1524 we cannot support H.R. 1524 in its entirety, although we do support, as I stated earlier, the concept of clearing up the tax liability question.

Thank you very much.

Mr. MATSUI. Thank you.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

SUMMARY

H.R. 1524 (Sec. 3) and H.R. 6503 (Sec. 2) contain language which would clear up a longstanding tax dispute between the U.S. Internal Revenue Service and certain utilities regulated by the California Public Utilities Commission. The resolution of this tax dispute is in the best interest of California ratepayers and the utilities which serve them.

H.R. 1524 (Sections 1 and 2) contains language which reaffirms the preemptive language of Sections 46(f) and 167(1) of the Internal Revenue Code and therefore is opposed by the NARUC.

Current tax law forces utility ratepayers to pay a rate of return to shareholders on capital which the shareholders have not provided.

The inequity created by current tax law is a clear violation of the time-honored principles of utility rate regulation and causes utility rate overcharges which are increasing annually.

Section 1 of H.R. 6503 would correct this problem with respect to future investment tax credits by more appropriately treating the ITC benefits as zero cost capital.

A recent study in the Journal of Business proves that the tax normalization technique mandated by H.R. 6503 would provive a more equitable sharing of the ITC benefits in a manner which is consistent with regulatory principles.

The NARUC urges that H.R. 6503 be given favorable consideration by this committee.

STATEMENT

Mr. Chairman and members of the committee; my name is Michael Foley. I am the Director of Financial Analysis for the National Association of Regulatory Utility Commissioner commonly known as the "NARUC".

The NARUC is a quasi-governmental nonprofit organization whose members include the regulatory bodies of the fifty States, the District of Columbia, Puerto Rico, and the Virgin Islands. The mission of the NARUC is to improve the quality and effectiveness of regulation for the benefit of the American people.

The members of the NARUC appreciates your invitation to make known their views on H.R. 1524 and H.R. 6503, bills relating to the tax and regulatory treatment of the Investment Tax Credit as utilized by rate-regulated corporations. The pri-

mary focus of both of the bills is an effort to clear up a longstanding tax dispute between the U.S. Internal Revenue Service and certain public utilities regulated by the California Public Utilities Commission. The NARUC recognizes that failure to resolve this issue could result in the collection of a multi-billion dollar tax liability from the utilities involved which would in turn have a pernicious impact on the ability of these firms to adequately serve consumers. A 1979 article published in Fortune magazine correctly asserted that collection of the billions of dollars in back taxes would cause modernization to cease, service to slump, and the ultimate loser would be the California ratepayers. Thus it is appropriate that Congress enact legislation which clearly is in the best interest of California ratepayers and the utilities which serve them. Section II of H.R. 6503 and Section III of H.R. 1524 accomplish this goal.

The evolution of corporate tax law during the past decade has been marked by an alarming tendency by Congress to preempt the ratemaking functions which historically have been vested with the State Regulatory Commissions. The Economic Recovery Tax Act of 1981 is a prime example of Federal intrusion in State ratemaking in that it requires the State commissions to implement normalization accounting treatment for those utilities which take advantage of accelerated depreciation and the investment tax credit.

The NARUC is opposed to Sections I and II of H.R. 1524 in that they reaffirm the preemptive language contained in Sections 46(f) and 167(1) of the Internal Revenue Code. Furthermore these sections of the bill delegate to the Secretary of the Treasuiry the right to "prescribe procedures and adjustments" to ratemaking treatments deemed inconsistent with the langauge of the bill.

It is the view of the NARUC that this represents an excessive delegation of regulatory authority to the Treasury Department and essentially allows the Secretary of the Treasury to get involved in public utility ratemaking—a function historically and properly reserved to the States.

The increasing complex and controversial nature of public utility regulation demands that decisions which directly impact the level of rates charged to consumers be made in the open forums of the State regulatory agencies.

Section 1 of H.R. 6503, however, contains language which would clean up a widely recognized technical flaw in the current normalization accounting treatment of the investment tax credit. Although H.R. 6503 would not return to the State commissions discretion as to the most appropriate accounting treatment to be employed on a case-by-case basis—it would enable the utility regulators to implement a normalization technique, known in the academic literature as "economic normalization", which unlike current normalization practices, is consistent with regulatory principles. Given the complex nature of this matter, the practical effects of H.R. 6503 (Section 1) can probably be viewed best by way of a hypothetical example.

Assume that a utility company purchases an asset which costs $100,000 and that this asset has a life of 10 years. Because the asset qualifies for the Investment Tax Credit, the utility company will be entitled to deduct 10 percent of the cost of the asset, (in this case, $10,000), from the tax obligation which the company would otherwise owe to the Federal government. Thus, the real cost of the asset to the company has been reduced to $90,000 since the government has in effect provided a $10,000 capital subsidy at zero cost to the utility.[1]

The controversy arises over how the benefit of this $10,000 ITC should be accounted for in the utility ratemaking process. Current tax law provides that there should be a sharing of the ITC benefits between utility shareholders and ratepayers via an accounting technique known as "normalization."

However, the vast majority of utility companies have elected a normalization option, known as "cost-of-service normalization," which is considerably more beneficial to shareholders, to the detriment of ratepayers. Furthermore, this normalization option is inconsistent with the time-honored principles of the regulatory process.

Applying cost-of-service normalization to the hypothetical case described earlier would call for the utility company to deduct one-tenth of the $10,000 ITC benefit from the amount of revenues which the utility would otherwise be allowed to collect from rate-payers during each year of the life of the asset. Thus, allowed revenues would be reduced by $1,000 annually over the 10-year life of the asset. During the 10-year period, the portion of the ITC benefits which have not yet been returned to ratepayers is listed on the company's balance sheet as an "accumulated deferred ITC" (ADITC).

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[1] It should be noted that current tax law is inconsistent in that it clearly recognizes accelerated depreciation tax benefits as zero cost capital but not ITC tax benefits. See Attachment A.

The inequity results from the current tax law which forces ratepayers to pay a rate-of-return on the ADITC's just as though the ITC benefits had been provided by the utility company's shareholders and bondholders. However, as the hypothetical example shows, none of the ITC benefits were provided by the utility's shareholders or bondholders but rather were provided as a capital subsidy at zero cost to the recipient utility.

The rate of return on ADITC's which utility consumers throughout the United States are being forced to shoulder is staggering and is actually increasing annually. In a 1981 report published by the Energy Information Administration, ADITC's of the 203 Class A and B privately owned electric utilities were reported to have increased nearly three quarters of a billion dollars in the 12-month period from year-end 1979 to year-end 1980 (see Exhibit #1). Needless to say, ADITC balances are also enormous and increasing rapidly in the gas and telephone industries (see Exhibit #2).

H.R. 6503 (Section 1) would allow utility companies to continue to enjoy the capital formation incentives created by the investment tax credit without forcing utility ratepayers to pay a rate of return on the ITC benefits. In essence, H.R. 6503 (Section 1) is a recognition that the ITC is a zero cost capital subsidy to industry. The language of this bill is consistent with the legislative history of the ITC which states in no uncertain terms that the investment tax credit will stimulate investment because, as a direct offset against the tax otherwise payable, it will reduce the cost of acquiring depreciable assets.

Thus, the legislative history indicates clearly that the ITC is not a tax reduction but is instead a government subsidy that reduces the private cost of depreciable business assets.[2]

In numerous hearings before the House Ways and Means Committee and Senate Finance Committee, utility representatives have repeatedly argued that implementation of economic normalization would destroy the concept that the ITC benefits should be shared by utility stockholders and ratepayers alike. Some utility representatives have gone on record as stating that economic normalization would "completely vitiate the very purpose sought by Congress in enacting the credit" or that economic normalization would "repeal the sharing concept enabling ratepayers to receive all the benefits of the ITC while the shareowner would receive none."[3]

There is no question that these statements reflect an erroneous view of the impact of economic normalization on ITC benefits. In fact a recent study published in the Journal of Business provides solid evidence that the position argued repeatedly before this and other Congressional Committees by utility representatives cannot be supported empirically. The Journal of Business article, authored by Dr. Donald Kiefer of the Congressional Research Service proves, by way of hypothetical example, (see Exhibit #3) that economic normalization provides for an appropriate sharing of ITC benefits without violating the logic of regulatory accounting.

Dr. Kiefer, who has performed exhaustive research in this area, concludes in his study that "economic normalization is consistent with the logic of the regulatory process, provides appropriate utility rate reductions to consumers, and benefits utility companies through higher cash flows while avoiding providing 'excess profits' to the utility."

I challenge any utility representative to refute the conclusions of Dr. Kiefer's research.

As the members of this committee are no doubt aware, the concept of economic normalization has been debated during hearings of the Congressional tax-writing committees on numerous occasions. In 1979 and again in 1980 Treasury officials of the Carter Administration testified in support of the concept of economic normalization. Interestingly, the original version of President Reagan's Economic Recovery Tax Act of 1981 (H.R. 2400 introduced by Rep. Conable, R-NY) contained language which if adopted would have implemented economic normalization.

This committee has once again been presented with an opportunity to correct a widely recognized technical flaw in the normalization accounting treatment of the investment tax credit. H.R. 6503 would accomplish that goal as well as resolve the longstanding tax dispute between certain utilities regulated by the California PUC and the IRS and therefore has the full support of the NARUC.

Thank you very much.

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[2] The AICPA generally accepted accounting principles also reflect this view. See Attachment B.

[3] Statements made by Theodore F. Brophy of General Telephone and Electronics Corporation and Robert N. Flint of American Telephone and Telegraph Company, respectively, during April 1, 1981 hearings of the U.S. House Ways and Means Committee.

Exhibit #1

Table 21- Privately Owned Classes A & B Electric Utilities
Composite Balance Sheet, 1971-1980

(Thousands of Dollars)

ITEM	1980	1979	1978	1977	1976	1975	1974	1973	1972	1971
ASSETS AND OTHER DEBITS										
UTILITY PLANT										
Electric utility plant	$180,821,329	$162,514,261	$170,834,972	$156,979,084	$143,044,797	$132,444,360	$121,600,621	$108,270,856	$96,304,038	$89,917,949
Electric construction work in progress	46,439,780	33,991,038	43,475,227	36,482,951	31,716,767	28,216,830	22,946,428	20,346,180	16,625,972	13,521,190
Total Electric Utility Plant	$226,261,079	$196,505,287	$214,310,199	$193,462,035	$174,761,564	$160,661,189	$144,547,051	$128,616,736	$112,930,010	$103,440,139
Elec. util. accum. prov. for deprec., depl., and amort.	52,705,597	47,507,780	42,921,476	38,741,589	34,898,201	31,389,241	28,558,127	25,904,554	24,309,972	22,425,056
Net Electric Utility Plant, Less Nuclear Fuel	$207,555,573	$168,997,507	$170,388,723	$154,421,446	$139,863,363	$127,273,939	$116,963,897	$102,612,221	$91,214,135	$81,013,149
Nuclear fuel	36,560,630	35,307,102	34,094,211	32,651,385	32,304,244	31,948,239	31,498,642	31,222,927	31,020,647	2861,691
Accum. prov. for amort. of nuclear fuel assemblies	2,748,821	2,091,500	1,541,044	1,072,868	758,984	509,068	318,895	215,540	128,647	78,812
Net Nuclear Fuel	33,913,799	33,715,303	33,139,167	33,579,077	32,005,259	31,439,163	31,183,806	31,007,387	2897,999	2713,879
Other utility plant	$14,402,529	$13,565,940	$12,944,702	$12,401,291	$11,913,022	$11,425,087	$10,997,319	$10,413,277	$9,889,481	$9,413,725
Other utility construction work in progress	369,530	302,727	287,384	218,546	162,977	146,737	203,434	883,701	344,894	122,160
Total Other Utility Plant	$14,772,059	$13,868,667	$13,182,086	$12,619,836	$12,075,999	$11,571,824	$11,200,753	$11,296,978	$10,234,467	$9,535,885
Other utility accum. prov. for deprec., depl., and amort.	4,834,836	4,217,958	3,982,978	3,662,455	3,367,287	3,107,982	2,864,781	2,670,975	2,502,412	2,219,864
Net Other Utility Plant	$10,288,242	$9,650,809	$9,204,013	$8,957,481	$8,708,813	$8,463,711	$8,435,152	$8,130,002	$7,731,845	$7,316,021
All utility plant	$220,255,430	$201,997,305	$188,488,886	$173,732,350	$157,764,972	$143,211,850	$134,137,702	$121,996,809	$108,810,146	$100,182,436
All utility plant construction work in progress	46,809,310	34,293,753	43,713,211	36,702,196	31,898,844	28,366,277	23,139,847	20,631,881	16,968,866	13,643,350
Total All Utility Plant	$251,714,740	$236,191,054	$232,101,096	$210,434,494	$189,663,917	$171,584,332	$157,257,600	$142,628,690	$125,779,214	$113,825,886
All utility accum. prov. for deprec., depl., and amort.	58,977,645	53,916,696	48,414,598	43,476,512	38,994,784	34,996,390	31,794,741	28,490,968	26,931,051	24,827,890
Net All Utility Plant	$221,737,115	$202,264,418	$183,708,563	$166,967,994	$150,729,133	$137,288,013	$125,552,965	$113,139,821	$98,943,163	$89,004,176
Utility plant adjustments	-	-	-	-	-	-	-	-	-	5547
OTHER PROPERTY AND INVESTMENTS										
Nonutility property less accum. prov. for deprec. and amort.	$361,556	$333,300	$280,970	$228,140	$199,597	$196,410	$233,332	$270,910	$171,172	$148,521
Investments in associated companies	341,334	223,336	107,296	336,602	366,457	253,247	182,113	179,730	2,010,366	1,772,440
Investments in subsidiary companies	4,686,727	4,312,209	4,799,836	4,128,115	3,732,870	3,281,964	2,972,997	2,665,627	-	-
Other investments	525,026	558,611	756,004	644,634	496,250	479,760	423,434	333,347	294,021	306,928
Special funds	414,672	302,563	443,772	307,304	253,511	186,308	199,336	113,999	28,223	17,130
Total Other Property and Investments	$6,329,317	$5,999,700	$6,373,310	$5,644,792	$5,021,685	$4,497,689	$4,011,213	$3,413,613	$3,504,982	$3,244,944
CURRENT AND ACCRUED ASSETS										
Cash	$660,979	$691,979	$690,358	$731,388	$870,821	$948,142	$863,294	$889,909	$824,578	$817,664
Special deposits	512,969	497,909	501,256	737,189	468,896	286,497	388,656	296,177	288,361	147,796
Working funds	54,765	72,065	67,683	56,549	44,700	40,495	43,129	34,144	30,929	28,298
Temporary cash investments	366,697	423,605	1,300,021	1,579,870	1,214,436	963,739	298,092	253,896	432,022	369,546
Notes and accounts receivable (net)	9,242,182	7,248,561	6,844,941	6,364,968	5,295,589	4,835,287	4,355,962	3,196,455	2,908,796	2,525,087
Receivables from associated companies	869,900	800,289	781,974	658,817	663,647	522,839	431,397	254,173	226,617	203,173
Materials and supplies	10,443,900	8,381,190	6,233,250	6,062,897	4,999,913	4,881,721	4,834,573	2,436,445	1,964,113	1,687,991
Prepayments	741,302	599,969	522,159	471,539	412,539	365,069	313,977	298,948	287,266	248,769
Other current and accrued assets	3,642,053	3,196,778	1,984,842	2,018,261	1,588,542	1,138,846	961,389	383,010	309,641	282,967
Total Current and Accrued Assets	$26,150,739	$23,434,813	$18,918,633	$18,181,830	$15,570,813	$13,539,897	$11,873,339	$7,754,827	$6,933,743	$6,886,606
DEFERRED DEBITS										
Unamortized debt expense	$426,804	$416,202	$381,585	$367,454	$320,500	$292,409	$283,398	$277,482	$174,007	$154,152
Extraordinary property losses	1,384,292	910,924	340,588	254,397	91,286	78,913	39,717	26,952	14,514	14,250
Preliminary survey and investigation charges	143,764	129,733	108,197	90,484	76,953	62,861	66,782	48,451	38,256	27,971
Clearing accounts	46,018	52,713	38,414	30,697	26,480	25,287	23,261	16,366	14,344	13,742
Deferred losses from disposition of utility plant	-	-	43,530	1,934	-	-	-	-	-	-
Research and development expenditures	18,472	24,223	24,246	22,397	19,862	17,827	14,884	-	-	-
Unamortized loss on reacquired debt	58,102	62,735	62,680	59,720	2,731	6,447	711	396	-	-
Accumulated deferred income taxes	749,734	559,662	349,892	192,284	103,131	70,535	33,843	-	-	-
Other deferred debits	2,842,098	1,960,256	1,462,965	1,288,581	1,242,758	1,170,845	1,149,923	863,280	339,815	260,996
Total Deferred Debits	$5,519,315	$4,148,498	$3,826,464	$2,308,707	$1,963,304	$1,691,280	$1,549,095	$1,099,536	$580,936	$469,102
TOTAL ASSETS AND OTHER DEBITS	$350,941,577	$324,834,151	$311,901,402	$292,804,723	$272,879,824	$247,304,489	$143,990,341	$134,194,827	$109,374,782	$97,816,404

Source: "Statistics of Privately Owned Electric Utilities;" EIA; 1980 edition; Pp. 28-29

Exhibit #1

Table 21- Privately Owned Classes A & B Electric Utilities
Composite Balance Sheet, 1971-1980 —Continued

(Thousands of Dollars)

ITEM	1980	1979	1978	1977	1976	1975	1974	1973	1972	1971
LIABILITIES AND OTHER CREDITS										
PROPRIETARY CAPITAL										
Common stock issued	$20,822,260	$20,227,460	$17,762,879	$15,704,367	$12,217,008	$10,976,197	$10,125,512	$17,766,200	$16,034,725	$14,524,716
Preferred stock issued	23,438,247	23,548,514	21,343,096	19,041,396	16,295,367	16,796,696	14,837,992	13,090,136	11,429,512	9,208,645
Capital stock subscribed, liability and premium	14,307,289	14,436,156	12,960,343	11,173,519	9,603,674	7,978,902	6,561,761	5,826,345	4,958,249	3,999,777
Other paid-in capital	4,016,979	3,897,471	3,374,032	4,020,557	4,272,396	3,928,791	2,979,858	2,609,440	1,992,527	1,657,719
Installments received on capital stock	2,160	1,980	1,870	1,511	1,276	1,226	625	1,797	4,042	4,319
Discount on capital stock	-17,811	-15,922	-6,696	-9,548	-8,548	-8,547	-8,547	-6,850	-6,852	-6,573
Capital stock expense	-518,581	-458,000	-424,965	-374,000	-321,181	-278,375	-211,743	-190,440	-166,794	-139,997
Retained earnings	22,711,369	21,025,056	19,276,545	17,639,087	16,223,997	14,967,562	13,299,194	12,396,499	11,224,586	10,139,360
Unappropriated undistributed subsidiary earnings	1,059,482	1,002,000	942,299	795,229	687,479	602,029	486,189	380,511		
Reacquired capital stock	-60,857	-9,005	-3,383	-5,273	-4,275	-2,387	-2,255	-1,779	-1,441	-2,730
Total Proprietary Capital	$104,483,489	$96,165,771	$87,267,453	$79,823,725	$71,966,624	$64,573,134	$57,196,524	$51,873,681	$46,427,271	$39,470,356
LONG TERM DEBT										
Bonds (less reacquired)	$94,573,078	$89,005,207	$84,223,916	$77,289,782	$72,191,645	$66,931,841	$61,137,998	$54,458,471	$50,177,649	$46,112,499
Advances from associated companies	483,286	197,242	193,940	291,563	194,564	105,385	49,497	62,103	74,387	71,387
Unamortized premium on long term debt	166,965	114,179	121,898	135,052	122,961	142,621	139,280	99,772		
Unamortized discount on long term debt (debit)	343,482	280,268	247,462	219,440	178,464	139,987	108,619	80,530		
Other long term debt	2,360,271	2,406,651	4,067,776	4,698,854	2,967,737	3,698,433	3,651,920	2,097,993	1,261,891	528,689
Total Long Term Debt	$105,357,040	$90,564,553	$88,555,073	$82,577,791	$76,210,323	$70,019,753	$64,496,974	$56,672,691	$51,433,127	$46,767,745
CURRENT AND ACCRUED LIABILITIES										
Notes payable	$4,990,289	$5,654,513	$3,540,168	$3,329,076	$2,995,335	$2,951,552	$4,885,963	$4,057,765	$2,970,010	$2,857,867
Accounts payable	7,530,961	6,641,896	5,560,980	4,564,348	3,895,196	3,161,986	2,971,230	2,246,482	1,909,903	1,570,290
Payables to associated companies	1,819,270	1,468,254	1,125,427	996,191	830,434	739,947	681,841	562,654	549,002	231,276
Taxes accrued	3,963,381	3,321,360	2,615,482	2,302,028	2,716,666	2,590,156	2,186,213	1,981,341	1,587,339	1,349,823
Interest accrued	2,215,545	1,910,962	1,727,597	1,577,560	1,468,171	1,289,491	1,136,464	996,677	751,813	692,273
Dividends declared	1,116,023	983,994	905,671	781,771	644,232	555,836	396,772	433,610	389,712	322,772
Tax collections payable	377,648	341,144	339,838	300,964	187,396	153,845	141,270	116,078	104,114	90,345
Other current and accrued liabilities	5,479,588	5,268,149	3,992,225	3,746,245	1,485,580	1,231,359	1,191,746	947,980	739,532	652,043
Total Current and Accrued Liabilities	$28,397,705	$25,590,532	$18,316,736	$16,685,204	$14,004,304	$13,668,090	$15,349,410	$12,962,583	$9,751,724	$7,917,640
DEFERRED CREDITS										
Customer advances for construction	$478,930	$400,488	$364,217	$308,882	$275,801	$193,931	$174,519	$150,723	$135,096	$110,123
Accumulated deferred investment tax credits	7,992,968	6,918,270	5,944,971	4,974,634	2,831,367	1,732,770	1,100,628	1,004,948	798,272	613,250
Deferred gains from disposition of utility plant	2,280	80,230	1,596	1,621	1,632	-	-	-	-	-
Unamortized gain on reacquired debt	120,582	96,115	97,910	37,686	23,443	11,150	5,486	6,552	-	-
Accumulated deferred income taxes	14,117,454	11,596,685	10,088,366	8,345,041	6,813,070	5,367,838	4,299,436	3,547,981	2,791,808	2,434,328
Other deferred credits	1,779,481	1,446,885	1,172,017	1,000,405	888,264	543,060	338,256	193,453	221,295	284,922
Total Deferred Credits	$23,491,785	$20,549,313	$16,606,676	$13,768,229	$10,833,567	$7,848,799	$5,918,499	$4,711,657	$3,946,998	$3,352,573
OPERATING RESERVES										
Total Operating Reserves	$331,531	$367,583	$310,482	$342,569	$725,905	$397,745	$177,734	$176,294	$195,712	$169,891
TOTAL LIABILITIES AND OTHER CREDITS	$258,061,577	$234,536,134	$211,057,400	$193,054,733	$173,679,835	$157,101,489	$143,990,241	$126,196,927	$109,574,793	$97,516,404

* Excluding nuclear fuel.

Note: Due to rounding detail may not add to totals.

Source: "Statistics of Privately Owned Electric Utilities;" EIA; 1980 edition; Pp.28-29

Exhibit #2

STATISTICS OF COMMUNICATIONS COMMON CARRIERS

TABLE 16.--STATISTICS OF TELEPHONE CARRIERS REPORTING ANNUALLY TO THE COMMISSION, AS OF DECEMBER 31, 1980 AND FOR YEAR THEN ENDED --CONTINUED

NO.	ITEM	1 ALL COMPANIES 1/	2 BELL SYSTEM 1/2/	3 AMERICAN TELEPHONE AND TELEGRAPH CO.	4 BELL OPERATING COMPANIES
	DEFERRED CREDITS:				
51	PREMIUM ON LONG-TERM DEBT	22,730,303	22,460,594	5,998,273	16,979,301
52	ACCUMULATED DEFERRED INCOME TAXES-ACCEL. TAX DEPREC.	14,482,011,058	13,554,519,814	600,999,931	12,963,532,883
53	UNAMORTIZED INVESTMENT CREDITS	6,581,677,157	6,095,122,348	321,148,214	5,783,974,134
54	ALL OTHER DEFERRED CREDITS	398,853,488	398,754,519	12,843,572	385,911,018
55	TOTAL DEFERRED CREDITS	21,483,272,543	19,970,862,275	940,994,990	19,029,997,368
56	TOTAL LIABILITIES	130,281,306,341	129,063,590,468	49,217,160,961	119,477,918,736
	INCOME AND RETAINED EARNINGS STATEMENT				
	TELEPHONE OPERATING INCOME:				
57	OPERATING REVENUES	58,630,386,086	51,047,883,295	4,811,582,357	48,319,540,940
58	OPERATING EXPENSES	37,308,781,043	34,909,986,490	3,634,498,083	33,549,037,388
59	NET OPERATING REVENUES	19,339,969,013	16,938,817,778	1,177,014,304	14,761,503,572
60	RENT FROM LEASE OF OPERATING PROPERTY	0	0	0	0
61	RENT FOR LEASE OF OPERATING PROPERTY	2,489,076	0	0	0
	TAXES AND INVESTMENT CREDITS:				
	TAXES:				
62	FEDERAL TAXES ON INCOME (OPERATING)	486,354,498	433,947,099	35,038,446	407,909,191
63	FEDERAL INCOME TAXES DEFERRED-ACCEL. TAX DEPRECIATION	2,468,929,734	2,319,099,964	184,224,894	2,165,471,309
64	STATE, COUNTY AND MUNICIPAL TAXES ON INCOME	417,278,828	396,840,660	18,883,522	399,957,138
65	PROPERTY TAXES	1,838,691,175	1,729,838,324	91,738,121	1,648,090,203
66	GROSS RECEIPTS TAXES	1,163,971,577	1,139,655,734	41,395,739	1,087,860,025
67	FEDERAL AND STATE SOCIAL SECURITY TAXES	1,035,630,681	981,818,860	89,994,338	891,822,522
68	OTHER TAXES	237,440,786	203,784,683	46,239,003	157,545,680
69	TOTAL TAXES	7,638,080,013	7,184,369,844	436,514,417	6,727,885,427
70	INCOME CREDITS FROM PRIOR DEFERRAL OF FED. INCOME TAX	523,989,622	512,794,798	47,703,789	465,081,007
71	INVESTMENT CREDITS--NET	1,317,183,968	1,113,847,829	98,101,942	1,049,496,983
72	NET OPERATING INCOME AFTER OPERATING TAX DEDUCTIONS	9,992,930,678	9,173,344,905	723,101,634	8,490,343,289
	OTHER INCOME:				
73	DIVIDEND INCOME	484,139,730	483,823,080	4,518,388,789	22,487,994
74	INTEREST CHARGED TO CONSTRUCTION	168,819,297	154,906,280	27,873,184	138,433,078
75	OTHER INTEREST INCOME	187,937,118	169,613,567	321,359,187	31,366,048
76	MISCELLANEOUS INCOME	23,790,909	15,029,131	15,896,178	- 286,047
77	TOTAL OTHER INCOME	864,348,754	823,372,038	4,783,416,318	179,999,971
78	MISCELLANEOUS DEDUCTIONS FROM INCOME	174,782,686	101,527,912	116,348,136	45,179,776
79	INCOME AVAILABLE FOR FIXED CHARGES	10,682,496,746	9,895,189,429	5,390,169,816	8,586,063,984
	FIXED CHARGES:				
80	INTEREST ON FUNDED DEBT	3,387,581,382	3,103,329,339	448,944,344	2,654,383,982
81	OTHER INTEREST DEDUCTIONS	686,467,537	681,371,196	11,372,544	673,006,293
82	ALL OTHER FIXED CHARGES	19,741,211	14,736,196	2,026,602	12,715,548
83	TOYAL FIXED CHARGES	4,072,790,130	3,719,337,671	462,343,490	3,340,104,829
84	INCOME BEFORE EXTRAORDINARY AND DELAYED ITEMS	6,609,706,616	6,115,851,759	4,927,826,326	5,244,959,036
85	EXTRAORDINARY AND DELAYED INCOME CREDITS	17,272,783	14,982,330	3,810,017	11,072,313
86	EXTRAORDINARY AND DELAYED INCOME CHARGES	12,879,864	12,987,749	2,384,106	10,403,643
87	INCOME TAX EFFECT OF EXTRAORD. AND DELAYED ITEMS--NET	1,293,092	472,282	883,329	- 381,585
88	NET INCOME	6,612,836,422	6,117,574,077	4,929,498,909	5,244,006,771
89	UNAPPROPRIATED RETAINED EARNINGS AT BEGINNING OF YEAR	31,443,439,420	30,350,981,725	9,778,629,035	10,977,823,366
90	MISCELLANEOUS CREDITS TO RETAINED EARNINGS	- 302,514,644	- 302,535,234	70	26,034
91	MISCELLANEOUS DEBITS TO RETAINED EARNINGS	58,378,914	57,819,919	3,718,933	1,614,404
92	RETAINED EARNINGS AVAILABLE FOR RESERV. OR APPROP	37,795,382,284	36,207,908,703	14,703,406,081	16,922,244,392
93	RESERVATIONS OF RETAINED EARNINGS	7,377,248	467,000	0	467,000
94	DIVIDEND APPROPRIATIONS	4/ 4,295,952,702	3,958,467,898	3,789,948,694	4,245,552,907
95	UNAPPROPRIATED RETAINED EARNINGS AT END OF YEAR	33,492,052,334	3/ 32,248,971,205	10,933,546,387	11,676,223,585
	DIVIDENDS				
	DIVIDENDS DECLARED:				
96	COMMON STOCK	5/ 4,086,383,861	3,774,446,232	3,619,479,026	4,308,086,087
97	AMOUNT PER $100 AVERAGE BOOK VALUE 6/	7.90	7.63	9.97	9.10
98	PREFERRED STOCK	5/ 210,048,845	184,021,666	170,389,668	37,467,740
99	RATE PER $100 PAR OR STATED VALUE 7/	7.75	7.74	7.61	8.09

Source: "Statistics of Communications Common Carriers;" FCC; 1980 edition; P. 29

Exhibit #3

HYPOTHETICAL EXAMPLE OF UTILITY REVENUES OVER THE LIFE OF AN ASSET UNDER ALTERNATIVE REGULATORY TREATMENTS OF THE INVESTMENT TAX CREDIT

Year	Accumulated Deferred Investment Tax Credit (Average) Cases 3,4,5,6	Utility Revenues					
				Normalization			
		Base Case 1	Flow Through 2	Rate Base 3	Cost of Service 4	Shortage 5	Economic 6
1	$4.83	$15.70	$-2.82	$15.09	$15.27	$15.89	$14.47
2	9.50	15.28	15.28	14.08	15.04	15.66	13.47
3	9.17	14.86	14.86	13.71	14.61	15.23	13.09
4	8.83	14.44	14.44	13.33	14.18	14.79	12.71
5	8.50	14.02	14.02	12.95	13.74	14.36	12.33
6	8.17	13.60	13.60	12.57	13.31	13.93	11.96
7	7.83	13.18	13.18	12.20	12.88	13.50	11.58
8	7.50	12.76	12.76	11.82	12.45	13.06	11.20
9	7.17	12.34	12.34	11.44	12.01	12.63	10.83
10	6.83	11.92	11.92	11.07	11.58	12.20	10.45
11	6.50	11.51	11.51	10.69	11.15	11.77	10.07
12	6.17	11.09	11.09	10.31	10.72	11.33	9.69
13	5.83	10.67	10.67	9.93	10.28	10.90	9.32
14	5.50	10.25	10.25	9.56	9.85	10.47	8.94
15	5.17	9.83	9.83	9.18	9.42	10.04	8.56
16	4.83	9.41	9.41	8.80	8.99	9.60	8.18
17	4.50	8.99	8.99	8.43	8.55	9.17	7.81
18	4.17	8.57	8.57	8.05	8.12	8.74	7.43
19	3.83	8.15	8.15	7.67	7.69	8.31	7.05
20	3.50	7.73	7.73	7.29	7.26	7.87	6.68
21	3.17	7.31	7.31	6.92	6.82	7.44	6.30
22	2.83	6.90	6.90	6.54	6.39	7.01	5.92
23	2.50	6.48	6.48	6.16	5.96	6.58	5.54
24	2.17	6.06	6.06	5.78	5.53	6.14	5.17
25	1.83	5.64	5.64	5.41	5.09	5.71	4.79
26	1.50	5.22	5.22	5.03	4.66	5.28	4.41
27	1.17	4.80	4.80	4.65	4.23	4.85	4.04
28	.83	4.38	4.38	4.28	3.80	4.41	3.66
29	.50	3.96	3.96	3.90	3.36	3.98	3.28
30	.17	3.54	3.54	3.52	2.93	3.55	2.90

Assumptions: Initial value of asset = $100.00, asset life = 30 years, tax rate = .46, allowed rate of return on equity = .113, interest rate on long-term debt = .0756, debt ratio = .625, portion of deferred taxes used to replace debt = .625.

Source: "The Effects of Alternative Regulatory Treatments of the Investment Tax Credit in the Public Utility Industry;" by Donald W. Kiefer; The Journal of Business; Oct., 1981; P.12

ATTACHMENT A. PROVISIONS OF THE INTERNAL REVENUE CODE THAT CREATED TAX-TIMING DIFFERENCES [1]

The statements in 1954 before the Congressional committees, in the Committee Reports and on the floor of Congress indicated that among other purposes, Congress intended that the acceleration of tax depreciation would generate capital for investment, thereby stimulating expansion, which would contribute to high levels of output and employment. The House Report stated: "The faster tax write-off would increase available working capital and materially aid growing businesses in the financing of their expansion" (House of Representatives Report No. 1337, 83rd Congress, 2nd Session, H.R. 8300). However, Congress only accelerated tax depreciation deductions; it did not increase total tax depreciation. Therefore, the economic benefit to the taxpayer arising from the use of accelerated tax depreciation is the time-value of the money because of the postponement of tax payments. The availability of these interest-free funds reduce the requirements for other sources of capital, thereby reducing capital costs.

ATTACHMENT B. THE INVESTMENT TAX CREDIT ENACTED IN 1962 [2]

The Accounting Principles promulgated by the American Institute of Certified Public Accountants have permitted two alternative accounting methods. The preferable method is based on the premise that the investment tax credit represents, in essence, a reduction in the cost of property and so the credit should be deferred in the year realized and flowed through to income as the property giving rise to the credit is depreciated. The alternative accounting method is based on the premise that the investment credit is a reduction in the effective income tax rate for the current year and therefore it should be accounted for as a reduction in current tax expense.

Shortly after the investment credit was enacted, the accounting profession came out with Opinion No. 2, which provided that the investment credit should be amortized to income over the life of the related property. Certain accounting firms believed that the investment credit was in fact a reduction in current tax expense and refused to follow the investment credit accounting prescribed by Opinion No. 2. Some parties in government commented that, if the credit were amortized to income over a period of years, the stimulative effect on reported income, which some claimed that Congress and the President had intended to result from the investment credit, would be dissipated.

Approximately two years later, the Accounting Principles Board issued its Opinion No. 4 in which the Board expressed its preference for the amortization method but stated that either the amortization or the initial year flow through method was an acceptable method of accounting. At the time Opinion No. 11 concerning tax-timing differences was being considered in 1967, the initial exposure drafts of the Opinion included the provision permitting only the amortization method for the investment credit. These provisions, however, were dropped from Opinion No. 11 as released.

As stated earlier, the rate-making treatment for the investment credit has largely followed the accounting treatment of amortizing the credit to income over the service life rather than recognizing the investment credit as an immediate reduction in cost of service. Because of regulatory lag and the sizeable fluctuations in the annual amounts of the investment credits generated each year, rate-making on an immediate year flow-through basis is often very difficult. Those states which initially used the initial year flow-through method soon adopted a three or five-year average period for such flow-through as a means of smoothing out the revenue requirements from year to year. Because of the elections in the 1971 and 1975 tax laws, most electric utilities are now substantially on the service life method.

Mr. MATSUI. I would call on, at this time, Mr. McCollam.

STATEMENT OF WILLIAM McCOLLAM, JR., PRESIDENT, EDISON ELECTRIC INSTITUTE

Mr. MCCOLLAM. Thank you, Mr. Chairman and members of the committee. I am William McCollam, Jr., president of the Edison

[1] Source: View of Arthur Anderson & Co. as expressed in report prepared for the U.S. Federal Energy Administration; March 1977; Pp. IV-31.

[2] Source: View of Arthur Anderson & Co. as expressed in report prepared for the U.S. Federal Energy Administration; March 1977; Pp. 59-61.

Electric Institute (the "Institute"), and I am here today to express the views of the Institute with respect to the two bills we have been talking about all this morning, H.R. 6503 and H.R. 1524. The Institute is the national association of investor-owned electric utilities in the United States. The member companies of the Institute supply more than 77 percent of all electric power generated in the United States and serve more than 76 percent of all ultimate customers of electricity.

I would like to first direct my remarks to H.R. 6503, section 1. The first section of that bill which was introduced by Congressman Stark would take away from electric utility companies capital that is needed in order to meet the Nation's energy needs, would result in a substantial loss of revenues to the Treasury, and is counter to the purposes of the investment credit. We do not agree with Mr. Foley on these issues.

Under existing law, utilities are assured that the benefits of the investment credit will be shared between a utility's customers and its stockholders. That is clearly the case. The sharing is accomplished under section 46(f) of the Internal Revenue Code by either first, reducing the base upon which a utility earns by the amount of the accumulated credit but not, at the same time, reflecting the investment credit as a reduction of the utility's cost of serving its customers or, alternatively, second, reducing the cost of service to its customers by the amount of the credit over the service life of the property which gave rise to the investment credit but not, at the same time, reducing the base upon which the utility earns.

Most of our member companies have adopted the second sharing alternative, under which first, electric utility customers benefit by having the amount of the credit applied to reduce electric rates over the service life of the related property and second, electric utility stockholders benefit by the utility's earning on the unamortized accumulated investment credit amount that is invested in utility plant, precisely what Congress had in mind in producing and creating an investment incentive in a very capital intensive industry.

Section 1 of H.R. 6503 would permit a regulatory commission to require a public utility to both reduce cost of service by the amount of the credit and reduce the base on which the utility is permitted to earn.

This bill would not only be detrimental to utility cash flows, but, as has been observed already, it would have a significant effect on Treasury revenues.

In the opinion of the electric utility industry, the proposal is unwise and undesirable, particularly under present economic circumstances. Although inflation has subsided somewhat, the cost of capital, as you are well aware, remains inordinately high, and we are a very capital intensive industry. It is higher than the rate of return that most regulatory commissions will allow on investment in plant. Regulated utilities, therefore, have a strong incentive not to invest in facilities to meet future electric needs, and that is part of the problem.

This recently was pointed out in a report issued by the Department of Energy, which warns:

Continued utility financial problems, against a background of modest demand growth, may cause a long term shortfall in electricity supply. If powerplants continue to be cancelled and deferred as they have been recently, supply sufficiency could be at risk in much of the country as early as 1990.

Under these circumstances, the Congress should make every effort to retain the present effect of the investment credit for utilities.

Section 1 of H.R. 6503 would tend to end the present sharing of investment credit benefits between a utility's customers and stockholders. This is not in line with congressional intent for the investment credit expressed by Congress since 1971. Similar measures to eliminate the present sharing of the investment credit between a utility's customers and its stockholders have been considered by your committee in the recent past and have been rejected. In the 96th Congress a prior version of Mr. Stark's bill (H.R. 3165) was defeated in committee by a vote of 28 to 6.

Section 1 of H.R. 6503 would be harmful to the financial condition of the electric utility industry and should not be adopted. The present sharing provisions for the investment, in our judgment, credit must be retained as they now stand to continue to aid in providing capital necessary to meet future electric needs. Therefore, the Institute strongly urges rejection of section 1 of H.R. 6503.

I would like to now address section 2 of H.R. 6503 and H.R. 1524. Both of these measures, as has been already pointed out, deal with the tax-related regulatory problems which arose in California.

As best can be determined, no electric utility company is directly affected by section 2 of H.R. 6503 or H.R. 1524. For this reason, the Institute has not taken a position on these measures. However, we urge that in its consideration of these measures, the committee take no action that could be considered to evidence a lack of commitment to the normalization principles currently reflected in the law by section 46(f), 167(i) and 168(e) of the Internal Revenue Code.

Mr. Chairman and members of the committee, I want to thank you for the opportunity to present our views on this important legislation which directly affects our industry.

Mr. MATSUI. Thank you, Mr. McCollam.

Mr. McGrath.

STATEMENT OF JEROME McGRATH, PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Mr. MCGRATH. Mr. Chairman and members of the committee, my name is Jerome McGrath, president of the Interstate Natural Gas Association of America [INGAA]. INGAA is a nonprofit national trade association whose membership consists of virtually all of the major interstate natural gas transmission companies in the United States. INGAA's members account for approximately 90 percent of the natural gas that is transported and sold in interstate commerce. All of our members are subject to regulation by the Federal Energy Regulatory Commission under the Natural Gas Act.

We appreciate this opportunity to present our views regarding H.R. 1524 and H.R. 6503.

Briefly stated, H.R. 1524 seeks to make more specific the Internal Revenue Code requirements governing the treatment of accelerated depreciation and the investment tax credit for regulated

utility ratemaking purposes as those requirements are found at sections 167(l) and 46(f) of the code. This bill would also give a congressional waiver to certain prior ratemaking procedures of State regulatory commissions in California which deviate from the principles Congress and the Internal Revenue Service have prescribed.

We recognize and are not unsympathetic with the situation in which certain major California public utilities now find themselves. These companies face a large Federal tax deficiency as a result of ratemaking decisions. However, we are not without concern about H.R. 1524. This stems from the possibility that the bill may be construed by some as a congressional license to depart from what is the clear Federal policy with respect to the treatment of accelerated depreciation and the investment tax credit for utility ratemaking purposes.

We would strongly urge the committee, therefore, to make absolutely certain that the bill is not to be construed as a precedent for saving other regulatory commissions from the folly of their ways. Further, we believe that the record should be clear that failure to comply in the future with the established normalization provisions set out in the Internal Revenue Code and regulations will result in the strict application of penalties which Congress has previously enacted.

With respect to H.R. 6503, we are strongly opposed to this bill. In my full statement, Mr. Chairman, we have set out in some detail the legislative history of the investment tax credit as it relates to regulated utilities in general, and to the natural gas pipeline in particular. I will not go through all the legislative history already developed in my statement. It is important to note, however, contrary to the statement made by Mr. Foley a moment ago, that enactment of section 46(f) by Congress was in response to its objective of promoting and encouraging capital formation by regulated public utilities.

In addition, section 46(f) requires that the tax benefits be used as Congress intended and prevents them from being diverted to some other purpose. H.R. 6503 contravenes this longstanding congressional intent. It would change the 9-year-old policy contained in section 46(f)(1) by denying permanent use of all of the investment tax credits to our pipeline members.

To change section 46(f) of the Internal Revenue Code at this time would seriously reduce and constrain the cash flow generation, and our earnings coverage protection for issuance of debt by denying the pipeline industry this valuable benefit. We estimate that over the next 20 years upward of $300 billion will be expended or needed by our industry for gas supply projects alone. Therefore, the current retention provisions of section 46(f) dealing with the investment tax credit are even more compelling today than they were at the time of the enactment, and should not be altered in any way.

In conclusion, section 46(f) (1) and (2) as presently drawn by Congress are important tools for capital formation—not price subsidies to be passed on to consumers. It is the appropriate methodology for the pipeline industry and has been recognized as such by the industry's regulatory agency. Continuation of the provisions of the investment tax credit for our pipeline companies as presently in the law stimulates increased business investment in plant and equip-

ment, encourages productivity and fosters economic growth and employment.

We have dealt at some length, Mr. Chairman, with H.R. 6503, and with good reason. We sincerely believe this is a major step backward. We strongly urge that this bill not be adopted in any form. For the reasons which I have previously outlined, we do not object to H.R. 1524. However, we urge that the record be clear that any future attempt to deviate from the established normalization formula which results in the full enforcement of the loss of the tax benefits as provided in the tax laws.

We appreciate the opportunity to present our statement and would be pleased to answer any questions.

Mr. MATSUI. Thank you.

[The prepared statement follows:]

STATEMENT OF JEROME MCGRATH, PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Mr. Chairman and members of the committee, I am Jerome J. McGrath, President of the Interstate Natural Gas Association of America (INGAA), INGAA is a non-profit national trade association whose membership consists of virtually all of the major interstate natural gas transmission companies in the United States. INGAA's members account for approximately 90 percent of the natural gas that is transported and sold in interstate commerce. All of our members are subject to regulation by the Federal Energy Regulatory Commission under the Natural Gas Act (15USC717, et seq.) and the Natural Gas Policy of 1978 (15 USC3301, et seq.).

We appreciate this opportunity to present our views regarding H.R. 1524 and H.R. 6503.

Briefly, stated, H.R. 1524 seeks to make more specific the internal Revenue Code requirements governing the treatment of accelerated depreciation and the investment tax credit for regulated utility rate making purposes as those requirements are found at section 167(l) and 46(f) of the code, H.R. 1524 would also give a Congressional waiver to certain prior rate making procedures of state regulatory commissions in California which deviate from the principles Congress and the Internal Revenue Service have prescribed regarding public utilities and which, if not forgiven by Congress, will cause the affected public utility companies to pay back very substantial amounts of the income tax benefits they have previously derived from accelerated depreciation and the investment tax credit.

We would not oppose legislation that would continue and endorse the rules that Congress and the I.R.S. have established with respect to the normalization of accelerated depreciation and the use of the investment tax credit by regulated utilities. For reasons I will develop, we do not, take a position on H.R. 1524 and we strenuously oppose H.R. 6503.

COMMENTS ON H.R. 1524

Our comments are directed to H.R. 1524 as introduced without any amendments.

We recognize and are not unsympathetic with the situation in which certain major California public utilities now find themselves. These companies face a large federal tax deficiency as a result of maladroit rate making decisions. However, we are not without concern about H.R. 1524. This stems from the possibility that the bill may be contruded by some as a Congressional license to depart from what is the clear Federal Policy with respect to the treatment of accelerated depreciation and the investment tax credit for utility rate making purposes. We would strongly urge that the Committee in its deliberations on H.R. 1524, make absolutely clear that the bill is not to be construed as a precedent for saving other regulatory commissions from the folly of their ways. Further, we believe the record should be clear that failure to comply in the future with the established normalization provisions set out in the Internal Revenue Code and Regulations will result in the strict application of penalties which Congress has previously enacted.

COMMENTS ON H.R. 6503

In order to delineate why we have such strong opposition to H.R. 6503, it would be well to examine the tax legislative history of the investment tax credit as it relates to regulated utilities in general and the pipeline industry in particular.

LEGISLATIVE BACKGROUND

There has existed for some time a Congressional intent that Federal agencies be granted the authority to assure interstate natural gas pipelines subject to their regulations a means for retaining certain tax benefits; in particular, investment tax credit. The rationale for so providing stemmed from the realization that this country's energy needs were so significant that the necessity clearly existed for assuring that the investment credit be retained by our industry in order to provide an important financing tool to meet our capital requirements associated with our continuing search for traditional and non-traditional sources of supply.

The purpose of the first enactment of the investment tax credit, in 1962, was "to encourage modernization and expansion of the Nation's productive facilities . . . by . . . increasing the earnings of new facilities . . .," and to do so "in the case of both regulated and "nonregulated industries. . . ." [1]

The investment tax credit provision was amended by the Revenue Act of 1964 to provide that Federal regulatory agencies could not require that the benefits of the credit be flowed through to a utility's customers. Congress expressed its intent in Section 203(e) of the Revenue Act of 1964. Explaining the need for this legislation, the Senate Finance Committee stated:

"This (flow-through) is clearly contrary to the intent of Congress in enacting the investment tax credit provision and as a result this bill contains a provision to the effect that it was and is not Congress's intention that the Federal regulatory agencies require the benefit of the investment credit to 'flow through' in this manner." [2]

From October 1966 to March 1967, the credit was suspended and later the credit was competely repealed by the Tax Reform Act of 1969. It was restored in 1971 and has been a part of the tax law since then, in restoring the credit, Congress addressed the regulatory aspect of the credit.

Generally, the 1971 Act provided in part, that interstate natural gas pipelines could retain the benefits of the investment tax credit. This procedure is found in Section 46(f) of the Code. In addition, restrictions regarding allowable rate making treatment were imposed in order to prevent tax revenue losses associated with flow-through and to retain for the natural gas pipeline industry the same incentives given by Congress to unregulated industries.

It is also significant to point out that in adopting the ESOP provisions of the Tax Reduction Act of 1975, Congress again provided additional capital formation incentives and once again reiterated its position regarding the prohibition of flow-through of such tax benefits.

The enactment of Section 46(f) by Congress was in response to its objective of promoting and encouraging capital formation by regulated public utilities. In addition, Section 46(f) requires that the tax benefit therein be used as Congress intended and prevents them from being diverted to some other purpose.

Section 46(f) has been effective and continues to be effective in meeting the above stated Congressional objectives. Section 46(f) has accomplished the following purpose:

(1) Capital is provided to interstate natural gas pipelines for the construction of plant and equipment necessary to meet this country's energy needs;

(2) This capital has stimulated investment in domestic gas explorations and a number of supplemental energy projects including LNG and synthetic gas from liquids and coal;

(3) The overall amount of outside financing required by these companies has been reduced;

(4) Interstate natural gas pipelines can more effectively compete with non-regulated industries for capital within the financial sector.

H.R. 6503 CONTRAVENES LONG-STANDING CONGRESSIONAL INTENT

The ability of interstate natural gas pipeline utilities to raise the substantial amounts of capital required to undertake new supply projects is vital to the energy

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[1] Statement by Managers on the Part of the House, cited in H.R. Rep. No. 749, 88th Cong., 1st Sess. p. 36.

[2] S. Rep. No. 830, 88th Cong., 3d Session p. 43 (1964).

interests of this nation. The importance of capital formation incentives in this regard cannot be overemphasized. Our dependence on increasingly precarious foreign supplies of energy has escalated—not decreased. In 1974, we imported 1.2 billion barrels of oil at a cost of about $14.6 billion; while in 1979, our imports were more than 2 billion barrels at a cost of over $48 billion. The Congress has already evidenced its concern over this problem by pursuing legislation designed to encourage development of domestic energy resources. Thus, it is widely recognized that the need for domestic supplies of energy, including natural gas, has not declined by, rather, has increased materially.

Moreover, because of the rapid inflation in prices and the more costly development of marginal and non-conventional sources of gas supply, the need for capital is vastly more acute today than it was in 1971 when the credit was restored. Coupled with this is the concommitant difficulty of arranging financing for these projects because of the magnitude of the capital requirements, investor uncertainty as to regulatory treatment and the long lead times. Lenders and equity investors require adequate assurance that the project sponsors will be able to maintain the debt service on these projects despite delays or even complete failures in bringing these projects on line.

In the event the benefits of the investment tax credit are materially reduced, natural gas pipelines would have to consider two costly alternatives to replace this lost internally generated capital, with no assurance of success. Increased sales of equity capital is the first possibility. This choice, however, leads to higher dividend payments occurring at a time when the formation of capital and not the reduction of capital is necessary. The other alternative is for the natural gas pipelines to sell additional debt, a rather unappetizing prospect given the state of the financial markets.

Other problems associated with the formation capital necessary to meet our increasing financing requirements involve high interest rates, environmental constraints on new construction, and regulatory lag. Much of our industry is confronted with the combined effects of high interest rates, the enormously costly environmental and licensing requirements applicable to new plant construction, and well known regulatory lag under conventional original cost rate regulation.

This regulatory lag is exacerbated during high interest rate periods because current utility rates are based upon outdated operating expense levels and the historical cost of facilities which are far less costly to build than those being constructed today.

Aggravating the interstate natural gas industry's difficulty in raising large amounts of capital is the moribund condition of the stock market and the almost dissolution of the long-term debt market for pipeline industry obligations. For this committee to now consider changing the nine-year old policy contained in section 46(f)(1), by denying permanent use of all the investment tax credits to pipelines is to exacerbate the situation at the worst possible time.

It has been reasonably estimated that during the next 20 years the natural gas industry will need new capital exceeding $300 billion. The lion's share of this amount will be spent on acquiring new gas supplies.

Moreover, pipelines are facing increasing competition from unregulated business in raising such capital in the money markets, and financial strength is of the utmost importance. To change Section 46(f) of the Internal Revenue Code would seriously reduce and constrain the cash flow generation and our earnings coverage protection (for issuance of debt) by denying us this valuable benefit. Therefore, the current retention provisions of Section 46(f) dealing with the investment tax credit are even more compelling now than they were at the time of enactment and should not be altered in any fashion.

Finally, the direct decrease in Federal income taxes paid to the Treasury as a result of the passage of H.R. 6503 must not be overlooked. At a time when ending the Federal deficits are running out of control, H.R. 1524 would decrease the revenues available to Treasury by decreasing the taxable incomes of the interstate natural gas industry.

CONCLUSION

As Section 46(f) (1) and (2) are presently drawn, the investment credit is used as Congress intended—as a tool for capital formation instead of a price subsidy to be passed on to consumers. It is the appropriate methodology for the pipeline industry and has been recognized as such by the industry's regulatory agency. Continuation of the provisions of the investment tax credit for pipeline companies as presently in

the law stimulates increased business investment in plant and equipment, encourages productivity and fosters economic growth and employment.

Mr. Chairman, our remarks have dealt, at length, with H.R. 6503 and with good reason. This proposal is a step backward and we strongly urge that H.R. 6503 should not be adopted in any form. Further, for the reasons previously given, we do not object to H.R. 1524, however, we urge that the record be clear that any future attempt to deviate from the established normalization formulas will result in the full enforcement of the loss of tax benefits as provided in the tax laws.

Thank you.

Mr. MATSUI. Mr. Foley, I am somewhat reluctant to ask you any questions right now because you are giving us just half a loaf. The half a loaf you support is the one that would be helpful to the three utilities that have been specifically burdened by this inequitable situation. But I think sections 1 and 2 of the legislation, H.R. 1524, are as important and, perhaps, in the long term, more important than the forgiveness aspect of the legislation.

If Congress passes legislation to provide for accelerated depreciation for utility companies, it would seem to me that we are making a clear statement of public policy: first, utilities are in poor financial shape, and therefore we want them to be in a position to have capital formation capabilities without having to go into the bond market where they would be competing with government and other types of financial agencies, but instead have the money made available to them through accelerated depreciation.

I can understand why you would like to do what you are suggesting, because you want some discretion yourself. You want to be in a position to be able to avoid national policy and intent of the Congress. That would be my understanding of your testimony as it pertains to sections 1 and 2. Would you comment?

Mr. FOLEY. Yes, I would be happy to. You have made several points. First, we have to bear in mind, not only is Congress preempting State regulatory policy, but also generally accepted accounting principles. The American Institute of Certified Public Accountants has held that both normalization and flow-through are generally accepted accounting principles. Yet you are telling the public utility industry that it is not generally acceptable for you to use flow-through accounting.

Mr. MATSUI. Why would we say to the utilities that you could accelerate your depreciation, unless we wanted them to use it for capital formation. If we want to give the ratepayers some relief on their energy costs, we could do it in some other ways. We don't have to do it by doing it through an accelerated depreciation or an ITC. Therefore, we would put you in a position where you can thwart our will. Address that issue, rather than the fact——

Mr. FOLEY. I think your question presumes that the State regulatory commissions are attempting to thwart the intent of Congress.

Mr. MATSUI. No, I am not suggesting that. Any number of them would probably use normalization.

Mr. FOLEY. That is correct.

Mr. MATSUI. I am suggesting that many of them would be in a position where they could thwart the will. You people are at a level where more pressure could be placed upon them, perhaps, and a number of other factors would be involved in the decision.

Mr. FOLEY. As I am sure you can appreciate, it is the State utility commissioners who are responsible for the level of rates that

are charged to the customers in their States. If Congress should pass along a tax break to the industry, which, of course, if you check the record, we have supported the tax breaks which have been available to industry. Our position has always been, if there is a tax break available to corporations, it ought to be available to all corporations, not just the unregulated corporations.

But we feel the State commissions fully must have discretion in setting accounting policy and regulatory policy, because they are the ones who are answerable to the ratepayers in the States.

Mr. MATSUI. I still don't think you have answered my basic question. You have made it your position to vitiate the intent and purpose of the legislation. And I don't know if you have answered that. I understand you would like as much discretion as you possibly could have. If I were in your position, I would, too. Perhaps I could ask one other question.

Just so that the record is clear in this respect—because the legislation is complicated—some people think that normalization means that you are going to give the utilities a windfall, or alternatively, you are going to be able to give stockholders a major windfall. Perhaps Mr. McCollam could respond to that question. Is, in fact, normalization a scheme or loophole just to give either utilities or stockholders a windfall?

Mr. MCCOLLAM. No, sir, Mr. Chairman, it is not. It is simply tax deferral, and the benefits of those taxes are spread over the life of the property. That is all it means.

Mr. MATSUI. Basically, it could help all the generations of ratepayers, is that correct, rather than just the immediate generation of ratepayers?

Mr. MCCOLLAM. That is correct. I believe you have stated the problem very succinctly in that if you flow all the tax benefits through currently, you are benefiting the immediate ratepayers, and not those that are going to be using the property over the useful life of the property.

Mr. MATSUI. Thank you. I would like to call on Mr. Duncan for questioning.

Mr. DUNCAN. Thank you, Mr. Chairman. I have no particular question other than to thank the panel. It has been very enlightening to know your position on this. I tend to agree with you. Thank you.

Mr. MATSUI. Mr. Stark.

Mr. STARK. Mr. McCollam, do you think that investor-owned electric utilities should pay income tax?

Mr. MCCOLLAM. Yes, sir, I do think they should pay income tax.

Mr. STARK. Any particular rate that you think they ought to pay?

Mr. MCCOLLAM. Would you repeat the question.

Mr. STARK. Do you think they ought to get a different rate from other businesses?

Mr. MCCOLLAM. I think the tax code provides for a uniform rate at the present time. We are not proposing any change be made in that.

Mr. STARK. Any idea what the electric utilities paid in taxes in recent years?

Mr. MCCOLLAM. Yes, sir. Our industry is currently paying about $1 billion in Federal income taxes. [Mr. McCollam supplied the following: Taxes paid in 1981 equals $2.1 billion.]

Mr. STARK. And what are the profits of your industry?

Mr. MCCOLLAM. I do not have the figures at hand but I can certainly provide them for the record, Mr. Stark.

Mr. STARK. Do you guess that they are $50 billion?

Mr. MCCOLLAM. I do not have the figures. I will provide them for the record. [Mr. McCollam supplied the following: Profits (net income) for 1981 equals $12.6 billion.]

Mr. STARK. Do you have any of those figures, Mr. McGrath, for the gas utilities?

Mr. MCGRATH. No, sir, I do not, except to State that the natural gas pipeline industry is a substantial taxpayer but I do not have that information with me. I would be pleased to supply it for the record.

Mr. STARK. I suspect that the utilities pay a very small percent of their profits in taxes and I have often advocated that we would save everybody a lot of trouble if we made utilities tax free, because they are indeed different from other profitmaking corporations. If we do put a user tax or an exise tax on the services provided by the utility, what would be the position of the regulatory authorities on that?

Mr. FOLEY. Well, I think you have put your finger on one of the true ironies of the Federal tax code as it currently exists. I would be willing to bet that if any Congressman were to introduce legislation which would exempt utility companies from paying income taxes, the biggest opponents of that bill would be the utility companies.

Mr. STARK. Do not take that bet. I have done it and you are absolutely right. They just say, oh no, they love the tax code.

Mr. FOLEY. Sure.

Mr. STARK. Would you like to explain to the committee why, in your opinion they love the tax code?

Mr. FOLEY. Because of their capital intensive nature they win much more from the current tax code than other industries. They, because of the whole deferred tax question, receive multibillion dollar interest free loans from the Federal Government which are cleared through the tax code.

Noncapital intensive or less capital intensive corporations do not have those kinds of benefits available to them and because of that reason, the utility really is a big winner from the tax code.

Mr. STARK. Can you see a situation where a utility would be encouraged to purchase a great deal of equipment because of the tax incentives or do utilities respond more directly to the demand of their customers?

Mr. FOLEY. That is a very theoretical question.

Mr. STARK. Well, let me ask do you make judgments as regulators on the necessity of the investment or do you leave that to the utilities?

Mr. FOLEY. I think the utilities are primarily responsible for serving the customers. They are primarily responsible for insuring that they have adequate plan on hand to service the customers. But the purpose of this tax break is to stimulate further invest-

ment beyond what one would ordinarily take in the course of business.

Mr. STARK. Let's say that a community was using, including peak demand and expansion for industry, 1 million cubic feet of gas a month and the utility had sufficient storage tanks to provide a million cubic feet of gas a month and that was the peak load and everybody projected that it could never go much beyond that because it was stagnant.

Let's say it was not growing much. If they came along and wanted to build a 2 billion or billion cubic foot per month storage facility, would the ratemakers just automatically adjust the rate to the present gas customers if your best estimate showed you they would not use that equipment for 10 or 15 years?

I made an extreme example but do you take into account the necessity of the investment when you set rates or not?

Mr. FOLEY. We certainly do. If it is found that the utility company is building up capacity beyond that which is considered prudent, the ratemakers in these instances would remove plant from rate base.

In other words, they will say, sure, you can go out and build those plants but do not come looking to us to collect a return on it. And because they send that message to the utility companies, clearly the utility is not going to go out and build plant unless they feel that they are going to be able to earn a return on it.

Mr. STARK. To justify its need?

Mr. FOLEY. Sure.

Mr. STARK. So the rate is set, in effect, on the demand.

Mr. FOLEY. Used and useful property, yes.

Mr. STARK. So, I guess what I am saying is that the tax incentives might very well speed up an investment decision by a year or two. That makes good sense.

Mr. FOLEY. That is the intent, of course.

Mr. STARK. But it certainly would be hard pressed to say that a utility would overexpand. You would not get paid for it, is that correct, if the regulation were working perfectly and we were in this wonderful theoretical world.

Mr. FOLEY. Again, if they thought they could get the plant into the rate base, then it would be in their interest to build the plant, and there is some evidence that the electric utility industry at least has reserve margins which are far beyond that which would be considered prudent.

Mr. STARK. If a purchasing agent for a utility got a 10 percent reduction in the price of a piece of capital equipment, would you let them take, let's say the full retail price into account for ratemaking, or would you take into account what they actually paid?

Mr. FOLEY. We would take into account what they actually paid.

Mr. STARK. When the taxpayers give them a discount through the investment tax credit, is not really what my bill tries to do is to just say you should not charge the poor ratepayers for something that did not cost the utility anything. The ratepayers are the ones who gave them the 10-percent discount in the first place through their taxes in the investment tax credit.

Mr. FOLEY. That is right.

Mr. STARK. I think you made very clear what is being obfuscated otherwise. Thank you very much.

Mr. MCGRATH. Mr. Chairman, I do not want my silence to indicate any agreement whatsoever with Mr. Foley's responses.

Mr. MATSUI. Perhaps your opportunity will come later.

Mr. Frenzel?

Mr. FRENZEL. Mr. Chairman, I think what bothered me about this problem when we took it up last year and still bothers me this year is a point I think you were trying to make to Mr. Foley and that is that Congress had something in mind when it passed the legislation, that it expected to have stimulated a certain type of capital investment and in the State of California almost uniquely around the world the local authorities made a unilateral decision that the moneys which were being provided by all the taxpayers of the United States would somehow have to flow back through to a certain select preferred elite consumer group in California who would have their rates reduced at the expense of my taxpayers in Minnesota.

That is a hard question for me to get around. We have discussed it at some length last year. I recall the testimony some of the city attorneys who were part of the process of going to court to get these rates reduced. I am a strong believer in states rights. I love to see the regulatory commissions carrying out their duties under the law and the constitution.

On the other hand, we have some duties here to the taxpayers on whom we relied to finance all of our national obligations, and I cannot understand, Mr. Foley, how you can defend a particular institution in a particular State attempting to flaunt our national intension.

Maybe you could explain that to me one more time.

Mr. FOLEY. I do not think it was ever the intention of the California PUC or any other PUC to attempt to compromise either the tax benefits that were available to the companies or to try to circumvent the law or to try to penalize ratepayers in your State to the benefit of ratepayers in another State.

I do not think that was ever their intent. I think they always operated in the best interest of the parties that they——

Mr. FRENZEL. I do not think they were necessarily hurting the ratepayers in my State. I think they were snookering the taxpayers in my State.

Mr. FOLEY. I meant to say taxpayers. I do not think that they were ever attempting to do that.

Mr. FRENZEL. You do not think that was the net result?

Mr. FOLEY. That is a difficult question to answer. It, of course would depend on whether or not the companies eventually have to pay the tax liability which has arisen.

Mr. FRENZEL. The other thing that worries me a little bit is in the olden days when Ma Bell was our single gigantic entity and it various components were able to borrow money under the aegis of the giant corporation, that was one thing. Now as we look forward to the future with the separate operating arms of this colossus, is it not true that the ratepayers in California are going to have to pay a lot higher interest charges for new construction and new investment?

Mr. FOLEY. I think there is some evidence that because the tax liability question forms, if you will, a cloud over the heads of these utility companies——

Mr. FRENZEL. I would phrase it quite a different way. I would say because of the mismanagement of the utlities out there, the upgrading and the investment has not been made. The moneys have not been made available to that company and for whatever happens in the future it is going to cost them a great deal more.

Mr. FOLEY. Well, there is one point that has not been addressed this morning, and that is why did the utility companies not take advantage of these tax benefits when they first became available?

I think that is really what invoked the ire of the California PUC that the utilities did not want to take advantage of these tax breaks for fear that they might have to share them with ratepayers.

Mr. FRENZEL. I think that that fear was wholly justified in the State of California because the pattern was quite clear that is exactly what that commission wanted to do. I would have been scared to death myself.

Mr. RUSSO. If the Gentleman would yield, I think that is an understatement.

Mr. FRENZEL. The utilities commission out there has had a towering reputation nationally. We all understand what has been happening out there. We have been horrified, of course, but until this thing came up it has been none of our business, but now it is our business because our taxpayers are involved.

Mr. FOLEY. As I am sure you can appeciate, the composition of any state PUC changes over time. A particular ratemaking technique which a commission might impose in 1970 might not necessarily be the same rate making technique which the commission would impose in 1980.

Mr. FRENZEL. Well, I would agree with you and yet commissions do tend to follow patterns. Is that commission appointed, by the way?

Mr. FOLEY. My understanding is that the California commission is appointed with the consent of the California Legislature.

Mr. FRENZEL. I thank you very much for your testimony.

Mr. MATSUI. Thank you, Mr. Frenzel.

Mr. Rousselot.

Mr. ROUSSELOT. Thank you, Mr. Chairman.

Would any of you gentlemen care to comment? We have the feeling here from listening to some of the opponents of the legislation H.R.1524 that somehow if that passes there is going to be some kind of a huge windfall to the utilities. Is that correct, Mr. McCollam?

Mr. MCCOLLAM. Mr. Rousellot, as I stated earlier in my testimony——

Mr. ROUSSELOT. I think you need to restate it.

Mr. MCCOLLAM. We have analyzed to the best of our ability the effect that your bill 1524 would have on the electric utility industry and it will not have any effect, therefore we have taken no position on this bill. We do strongly oppose, though, the section 1, as I indicated in my testimony of H.R. 6503.

Mr. MCGRATH. Congressman, with respect to H.R.1524, we really are somewhat in the same posture as Mr. McCollam in that we do not take a position directly so far as the bill is concerned except our concerns that it not establish a precedent for other States to follow, that they can always come to Congress for a bailout, if you will, if they fall into error.

I think your broader question goes to the question of normalization and whether there is a windfall there for the companies, and that is certainly not true at all. It is a deferral of the tax as Mr. McCollam pointed out earlier to a question from Mr. Matsui.

The investment credit and the right to normalize is a key element in our industry for the tremendously costly investments that our company makes to serve the public.

Mr. ROUSSELOT. So they will still be paying taxes?

Mr. MCGRATH. Yes, sir, they will.

Mr. ROUSSELOT. Mr. Foley, are you a member of the board of your organization?

Mr. FOLEY. I am on the staff, sir.

Mr. ROUSSELOT. But you are not a board member?

Mr. FOLEY. No, I am not.

Mr. ROUSSELOT. Has your board voted for this position you stated here today?

Mr. FOLEY. Our association has passed numerous resolutions——

Mr. ROUSSELOT. Have you voted to oppose 1524?

Mr. FOLEY. As I started to say, Congressman, our association has passed numerous resolutions which are germane to both of the bills.

Mr. ROUSSELOT. Has your Board, of which you are not a member, voted to oppose H.R. 1524?

Mr. FOLEY. They have not passed a resolution which directly states that H.R. 1524 is to be opposed—no.

Mr. ROUSSELOT. I realize you have picked up certain sections. You say that H.R. 1524 contains language which would clear up a longstanding tax dispute between the U.S. Internal Revenue Service and certain utilities regulated by the California Public Utilities Commission. The resolution of this tax dispute is in the best interest of California ratepayers and the utilities which serve them. But I wondered if your board had asked you to come up here and specifically oppose 1524 and they did not ask you to do that.

Mr. FOLEY. Well, we do not oppose 1524 in its entirety.

Mr. ROUSSELOT. I appreciate you specifying where you think there are problems. But they did not ask you to come up and oppose it.

Mr. FOLEY. No; the truth of the matter is that I have been asked to come up here to support specific sections of that bill.

Mr. ROUSSELOT. I appreciate that.

Thank you, Mr. Chairman.

Mr. MATSUI. Thank you, Mr. Rousselot.

I would just like to make one comment. I think the comments made by Mr. Frenzel underscore the problem that you face when different utiilties do different things in terms of the normalization issue, and that is why I think it is so important that sections 1 and 2 actually ratify what I believe the current law to be.

In addition to that, I would like to make one clarification. The method that the California utilities had to use at the request of the PUC. The 1960's was an AAA method of accounting established in the 1960's, but this formula did not flow through all the benefits of the accelerated depreciation—rather only a part of the benefits. Nevertheless, the Internal Revenue Service has denied all of the tax benefits of accelerated depreciation to these three utilities.

I just thought I would clarify that, although you may have known it, for the record.

Mr. FRENZEL. Well, I thank the chairman for explaining that to me.

Mr. Chairman, may I ask some of the witnesses who are opposed to section 1 what they would suggest in its place?

Mr. FOLEY. Congressman, I think that so long as the Treasury Department, Senate Finance Committee, and the House Ways and Means Committee involve themselves in public utility ratemaking, that we are going to be seeing each other again and again and again. I do not think there is any reason to believe that this is going to set this matter to rest forever.

I think the House Ways and Means Committee has clearly crossed over the line now into State public utility ratemaking and I suspect we will be back here.

Mr. MCCOLLAM. May I comment also, Mr. Chairman. The point that is repeatedly being missed, it seems to me, by Mr. Foley is the question of capital formation. We have an extremely capital-intensive industry. Certainly I speak for one; we are the most capital intensive industry.

We are simply not going to be able to attract the capital in our industry if we do not have the incentive for investors to invest in our industry.

The question of public policy which we have referred to repeatedly this morning which has been enunciated by the Congress is one to promote capital formation by giving incentives to the investor. That is what is being overlooked by Mr. Foley.

Mr. FRENZEL. I agree with you. California found a way to snatch some tax money and give it back to phone users but if we were devising a tax system now, how would you prevent that sort of conduct?

If you have a wanton utilities regulation commission, how do you prevent them from doing that? How do you direct the money?

Mr. MCCOLLAM. I think what has been specified in terms of public policy and enacted by the Congress and current legislation is precisely the way we should go, and we should continue to go. We should not change that legislation.

Mr. MCGRATH. I think you have existing penalties in the law, Congressman. Enforce those penalties.

Mr. FRENZEL. Thank you very much.

Mr. MATSUI. Thank you, Mr. Frenzel.

I would like to thank the three gentleman from the panel for being here today, and I would like to thank the members of the committee, and the meeting is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[The following were submitted for the record:]

STATEMENT OF THE AMERICAN GAS ASSOCIATION

The American Gas Association (A.G.A.) is a national trade association comprised of nearly 300 natural gas transmission and distribution companies which provide natural gas to approximatly 160 million consumers in all 50 states. Indeed, A.G.A member companies account for about 85 percent of all natural gas utility sales in our nation.

A.G.A. appreciates this opportunity to express its views on this legislation. Also, A.G.A.'s views on another normalization related matter (Section 209(d)(1) of the Economic Recovery Tax Act of 1981 regarding the normalization transition rule) are being submitted for the record by separate letter from the law firm of Miller & Chevalier on behalf of A.G.A. We believe it is important to outline some general parameters and considerations pertaining to the financial structure and capital requirements of the regulated gas utility industry before specifically addressing the instant legislation.

INTRODUCTION

Natural gas currently provides over 30 percent of total U.S. energy supplies. Gas is used in about 55 percent of all residences and commercial establishments in our nation and provides some 40 percent of the energy consumed by U.S. industry and agriculture. More gas is produced domestically than any other fuel on an energy content basis.

However, unreasonably low wellhead pricing regulations in the past have resulted in natural gas curtailments, thereby contributing to an intolerable increased dependence on foreign oil imports. This growth in oil imports have steadily aggravated our foreign balance of payments deficit, has contributed substantially to the domestic rate of inflation, and has in the past contributed to the decline in the value of the dollar versus foreign currencies. Therefore, fostering the development of supplemental and conventional gas supplies can help meet the growth in U.S. energy requirements and alleviate the problems created by reliance on foreign oil imports.

CAPITAL REQUIREMENTS OF THE NATURAL GAS INDUSTRY

A.G.A. believes that it is necessary for our nation to embrace both energy and tax policies that will permit formation of sufficient capital to finance the development of new natural gas supplies to meet growing energy requirements. As an industry, we know that we must engage in a substantial capital expenditure program to develop new sources of gas. Development of these sources is, in general, more capital-intensive than traditional pipeline and utility construction projects. We anticipate capital requirements associated with new gas supply projects to total about $352 billion (1982 dollars) between now and the end of this century.[1] If we add these capital requirements to the more traditional requirements for transmission and distribution system construction, which total $129 billion (1982 dollars), it is clear that by the end of this century,, an estimated $482 billion (1982 dollars) of additional investment by the natural gas utility industry will be required.

The ability of the U.S. gas utility industry to attract this level of investment will require a legislative and regulatory environment that favors growth of the industry and a level of return on investment which is competitive with other opportunities in the capital markets. Federal policy will play a significant role in determining the ability of the natural gas utility industry to raise the large amounts of capital necessary to finance conventional exploration and development as well as such vital projects as the Northwest Alaskan Pipeline, coal gasification plants, and large LNG projects. Federal policies must be developed with cognizance of the long lead times involved in the construction of such large projects, and with an appreciation of the unique problems the regulated natural gas utility industry faces in its efforts to secure sufficient capital to finance these projects.

It is from the above perspective the A.G.A. strenuously opposes the enactment of H.R. 6503 for the reasons set forth below.

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[1] This projection of capital needed to develop new gas supplies is based on the funds necessary to meet the supply scenario termed the "North American Focus" which is outlined in the A.G.A. Gas Supply Committee report, "The Gas Energy Supply Outlook: 1980–2000," January 1982.

SUMMARY OF A.G.A. COMMENTS AND RECOMMENDATIONS

The ability of the regulated gas utility industry to develop future gas supplies is greatly enhanced by the utilization of tax normalization. Many regulating agencies recognize this fact and, most importantly, Congress reiterated its intent to require normalization of the investment tax credit in the Economic Recovery Tax Act of 1981. (See I, infra.)

The specific sections of the Internal Revenue Code (IRC) permitting normalization have helped the industry to formulate much needed working capital over the years. (See II, infra.)

With respect to a utility's ratepayers, normalization is both a beneficial and an equitable method of treating the investment tax credit. (See III, infra.)

H.R. 6503 would not prohibit state regulatory commissions from reducing both the utility taxpayer's rate base and cost of service in order to flow-through the investment tax credit. (See IV, infra.)

In permitting both a cost-of-service and a rate base reduction, H.R. 6503 could cause a decrease in federal revenues because of reduced taxable income to utilities. (See V, infra.)

i. Many regulatory agencies recognize tax normalization as an equitable and fair method

The gas industry's ability to supply future demands for gaseous energy reliably is contingent on its ability to finance gas supply activities, as discussed supra. The financing is affected by cash flow, coverage ratios, capital structure, quality of earnings, etc.—all of which are improved by use of tax normalization.

Regulators are aware of this and as a result there has been a trend toward more tax normalization in recent years in order to take advantage of these benefits. In recent times, many of those agencies which originally adopted the flow-through method have changed their position and now advocate the normalization approach. A good example is the Interstate Commerce Commission (ICC) which issued an order in 1974 requiring normalization accounting for all timing differences. This ICC action represented a complete reversal of its prior position requiring flow-through of the amounts involved in these timing differences.

Other federal regulatory agencies have also recognized the desirability of normalization. For example, the Federal Communications Commission amended its accounting system in 1970 to allow normalization accounting. The Civil Aeronautics Board has been a proponent of normalization from that agency's inception. The Securities and Exchange Commission has taken a strong position in support of normalization concepts as the appropriate method of financial reporting. Also, there are 10 to 12 state regulatory agencies which have made similar changes from complete flow-through to limited or complete normalization since the Revenue Act of 1971.

In a recently issued final rule regarding tax normalization for certain items reflecting timing differences, the Federal Energy Regulatory Commission (FERC) has wholeheartedly embraced the concept of normalization over that of flow-through in Order 144-A issued February 22, 1982.[2] One of FERC's purposes in this rulemaking was to "eliminate ongoing controversy and attendant uncertainty regarding the appropriate treatment of the timing difference transactions in Commission rate proceedings by establishing a general rule sanctioning normalization." Indeed, after evaluating the relative merits of both policies (*i.e.,* normalization and flow-through) in the proposed rulemaking stage the Commission concluded that—

"The normalization policy more equitably balances the interests of present and future ratepayers by matching the interperiod allocation of tax benefits to the interperiod recovery of expenses. Normalization also achieves this objective by improving utilities' ability to attract capital and maintain cash flow and thereby to provide adequate service reliably over the long term. Normalization does not permit stockholders to realize rates of return higher than those allowed." [3]

In addition to this historical regulatory support for the concept of normalization, A.G.A. believes that persuasive evidence of the long-standing congressional intent on this issue is embodied in the Statement of the Managers of the Economic Recovery Tax Act of 1981 (ERTA). In referring to the alternate methods of ITC normalization under current law in IRC sections 46(f) (1) or (2), the ERTA conference agreement clearly states under the heading "Normalization rules for public utility property" that ". . . normalization [under the current methods available] of the investment credit is mandatory . . ." [4] (Clarification added.) Congressional endorsement

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[2] 47 *Fed. Reg.* 8329—8342; February 26, 1982.
[3] 45 *Fed. Reg.* at 22061; April 3, 1980.
[4] H. Rept. No. 215, 97th Cong., 1st Sess. 215 (1981).

and approval of the current ITC normalization law could not be more explicit and, therefore, the ill-advised modifications of ITC normalization proposed in H.R. 6503 should be discredited as contravening this clear and long-standing congressional intent.

A.G.A. believes that these developments very clearly and forcefully substantiate the long-standing arguments in support of comprehensive normalization. The test of time has proven that the application of the flow-through concept for ratemaking purposes is not appropriate, and should be abandoned. A.G.A. has specifically testified in this regard over the past several years before the House Ways and Means Committee and the Senate Finance Committee concerning various legislative proposals dealing with the investment tax credit.

II. Section 46(f) options have greatly helped the gas industry form capital

A 1979 survey conducted by A.G.A. indicated that gas utility use of the Section 46(f) normalization options accounted for a significant capital investment pool. According to 1978 *pro forma* figures, the first option [Section 46(f)(1)] yielded $23.4 million; the second option [Section 46(f)(2)] yielded $78.5 million; and the third option [Section 46(f)(3) yielded $11.2 million for a total of $113.2 million. Indeed, utilization by the regulated natural gas industry of Section 46 (f)(1) and (2) benefits for the four years from 1975 to 1978 has provided a capital investment pool of $920 million.

It is readily apparent that these normalization provisions can, and do, contribute significantly to help meet the capital requirements of the regulated natural gas utility industry. The specific modifications of Section 46(f) contemplated by H.R. 6503, however, are certain to have a stifling effect on the gas utility industry's ability to accumulate capital. Currently, the high cost of capital presents a major hurdle to all potential investment projects. Adopting H.R. 6503 would result in even higher capital costs for utility ratepayers. By so doing, this legislation would impose significant barriers to the development of supplemental natural gas supply projects and would operate to frustrate our nation's goal of decreasing our reliance on foreign oil.

III. Normalization is fair and equitable for all ratepayers

Nothwithstanding the fact that tax benefits under the existing provisions are not immediately passed on to the consumer, the end result of the existing provisions is nevertheless beneficial and equitable to all ratepayers, both present and future. Savings from lower costs of capital resulting from the interest-free funds provided by the investment tax credit are passed on to the consumer because such costs are not incurred by the utility taxpayer. In addition, customers served during an assset's life benefit from the stimulation of productivity which results from the additional working capital provided by the credit.

The flow-through concept embodied by H.R. 6503 would allow current ratepayers to reap short-term benefits through temporary rate and cost-of-service reductions while denying utilities added capital formation necessary for purchasing new plant and equipment and engaging in supplemental supply exploration. Reaping these short-term benefits could well be at the expense, and to the detriment, of future ratepayers. The existing investment tax credit provisions of Section 46(f) promote economic growth, increased productivity and employment, and ultimately serve to help achieve energy independence by funding supplemental energy supply projects.

IV. H.R. 6503 creates the possibility of accelerated flow-through by the state regulatory authority

Because Congress intended the investment tax credit to serve as an incentive for plant modernization and expansion, the current law in IRC Section 46(f) permits the amount of the credit to be shared equitably by a utility's ratepayers and shareholders. This is accomplished generally by the utility either reducing its rate base by the amount of the credit (and restoring it ratably over the book life of the asset) or reducing its cost-of-service in ratable amounts over the book life of the asset. Reducing both the utility's rate base and cost-of-service violates the ratemaking treatment prescribed by Congress. Such a double reduction would dilute the effectiveness of the credit as an investment and expansion incentive.

Under H.R. 6503, however, a state regulatory authority would be permitted to reduce the utility taxpayer's rate base in addition to a ratable reduction over the life of the asset in the utility taxpayer's cost-of-service. This would result in serious cash flow problems for the utility and would also rapidly deplete the utility's working capital reserve.

V. H.R. 6503 could cause a reduction in Federal Treasury revenue receipts

As discussed above, H.R. 6503 would not prohibit a state regulatory authority from reducing both the utility's cost-of-service and its rate base. If a state commis-

sion did require this double reduction, there would be a direct reduction in the amount of gross revenues and taxable income flowing to the utility and, therefore, a corresponding reduction in federal income tax revenues received by the U.S. Treasury. At a time of federal budget deficit estimates in excess of $100 billion, such a reduction in federal revenues is unwarranted and ill-advised.

CONCLUSION

Present tax normalization provisions under Section 46(f) of the IRC provide fair and equitable treatment for both the utility and the utility's ratepayers with respect to the investment tax credit. This present treatment is a product of long-standing congressional policy which provides for a sharing of the benefits available under the investment tax credit. Moreover, present tax normalization treatment affords the utility an important working capital pool from which the utility can draw to finance supplemental gas supply projects. For these reasons, the present tax normalization provisions will not only enhance the development of our domestic natural gas supply, but will also help us achieve our national goal of energy independence.

H.R. 6503 would essentially undermine all of the above attributes of tax normalization and would provide for a short-sighted and ill-advised flow-through of the tax benefits to the utility ratepayers. While this flow-through would provide for immediately lower rates for the ratepayers, it would deny the the utility the working capital it needs to embark on supplemental and conventional gas supply projects and, therefore, in the long-term result in higher rates for the ratepayer. H.R. 6503 is essentially against the best interests of our nation and would act to frustrate the achievement of our strategic national objective of energy independence. Also, this legislation would very likely reduce utility income tax receipts by the U.S. Treasury. Therefore, A.G.A. strongly opposes the enactment of H.R. 6503.

MILLER & CHEVALIER,
Washington, D.C., June 21, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is submitted on behalf of the American Gas Association for inclusion in the record of the hearing announced in Press Release Nos. 35 and 36 on H.R. 1524 and H.R. 6503 relating to the accounting treatment of the investment tax credit and accelerated depreciation for public utility ratemaking purposes.

In enacting the Accelerated Cost Recovery System, Congress provided in new Code section 168(e)(3) that public utilities must use a normalization method of accounting to obtain the benefits of ACRS. To provide public utilities and their ratemaking commissions with a reasonable time to conform to the new normalization requirements, however, Congress further provided in section 209(d)(1) of the Economic Recovery Tax Act that failure to satisfy the new normalization requirements during a transition period would not result in a loss of the benefits of ACRS.

We would like to call the Committee's attention to an interpretation of these provisions by the Internal Revenue Service (in News Release IR-82-25) which is inconsistent with the pertinent statutory provisions as well as Congressional intent. Notwithstanding the transition rule set forth by Congress in section 209(d)(1) of ERTA the Revenue Service has imposed a type of normalization requirement on public utilities during the transition period. The attached memorandum describes the action of the Service and the statutory background in greater detail.

We have discussed this erroneous action of the Revenue Service with Assistant Secretary of the Treasury Chapoton and are hopeful the Treasury Department will take action to rectify matters. We believe it would be helpful to Treasury in these efforts if the Committee clarified Congressional intent with respect to the application of the transition rule in section 209(d)(1) of the Economic Recovery Act. This could be accomplished by the inclusion in the report of the Committee on legislation of the type which is the subject of this hearing or in the Committee's report on such other legislation as the Committee believes more appropriate (for example H.R. 6056, the Technical Corrections bill) of a statement to the effect that in enacting section 209(d) of ERTA Congress intended to relieve public utilities during the specified transition period from any type of normalization requirement under Code section 168(e)(3) (for ratemaking purposes, financial reporting purposes, or otherwise)

provided the utility's existing rate order met the requirements of Code Section 167(1).

Respectfully,

DENNIS P. BEDELL.

Attachment.

PUBLIC UTILITIES—TRANSITION PERIOD NORMALIZATION

The position taken by Treasury and the Revenue Service in News Release IR-82-25, which imposes on public utilities a type of ACRS normalization requirement for financial reporting purposes only, is improper and contrary to the statute.

Congress provided in Code section 168(e)(3) that public utility property is eligible for ACRS only if a normalization method of accounting is used. In defining normalization for this purpose, Congress adopted the concept present since 1969 in section 167(1) that essentially the small depreciation must be used by the utility to compute tax expense and depreciation expense "for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account."

Section 209(d)(1) of ERTA, entitled "Transitional Rule for Normalization Requirements," postponed the applicability of the new normalization requirement, however, until the earlier of the public utility's first post-ERTA general rate order or January 1, 1983 to allow utilities and regulators time to conform to the requirement. The News Release recognizes that because of this transition rule taxpayers "generally are not required to adopt the new normalization method of accounting to reflect operating results in regulated books of account until the first rate order becomes effective."

The News Release, however, then goes on the create a peculiar type of normalization requirement during the transition period (namely, normalization of the difference between ACRS tax benefits and the tax benefits the taxpayer would have received under its depreciation method used prior to ERTA, ADR in most cases) for book and financial statement purposes—but not for ratemaking purposes. Failure to satisfy this News Release requirement is stated to cause loss of ACRS for public utility property placed in service in the transition period.

Both premises on which this peculiar transition period, financial statement normalization requirement must rest are plainly erroneous: First, section 168(e)(3) does not provide any separate normalization requirement for financial reporting purposes, independent of normalization for ratemaking purposes; and second, the ERTA section 209(d)(1) transition rule does not permit any normalization requirement, general or limited, during the transition period. (H. Rep. No. 97-201, p. 87 (1981)).

Apparently, the Revenue Service attempts to infer a separate financial reporting normalization requirement from the section 168(e)(3) language referring to the taxpayer's "regulated books of account," Neither history nor logic, however, support such a reading. The normalization requirement of section 168(e)(3) is clearly the same concept as that found in section 167(1) which was adopted in the 1969 Act. The 1969 Act requirement that normalization be used in the taxpayer's regulated books of account was not, and was not intended to be, an independent financial reporting requirement; rather, normalization on the regulated books was simply part of the enforcement mechanism for the requirement that normalization be used for ratemaking purposes. (See S. Rep. No. 91-552, p. 174 (1969)).

Moreover, regulatory orders do not specify how the regulated books of account are to be maintained for any purpose other than reflecting ratemaking treatment. Regulatory orders specify the manner in which rates are determined. The regulated books of account are then kept in a manner consistent with the regulatory order determining rates. In other words, in regulatory practice no distinction is made between the treatment of an item in the rate order and in the regulated books of account: the latter automatically follows the former.

The ERTA section 209(d)(1) normalization requirement transition rule recognizes that the only pertinent regulatory orders in the context of normalization are those affecting rates. The rule provides that for the transition period the utility will not fail to meet the requirments of Code section 168(e)(3) where by the terms of a pre-ERTA "rate order" the utility must use an accounting method other than a normalization one, if by the terms of its first post-ERTA "rate order determining cost of service" the utility does use a normalization method.

Moreover, the financial reporting normalization requirement imposed during the transition period by the Treasury has no relation to the purpose—in 1969 and in 1981—of the statutory normalization requirement: namely, to mitigate the federal revenue loss which would occur if the tax benefits were flowed through to custom-

ers, rather than normalized, for ratemaking purposes. The News Release normalization requirement will not have any effect on the revenues or on the administration of the tax laws. It will only affect book and financial statement reporting.

STATEMENT OF CONTINENTAL TELECOM, INC.

Continental Telecom Inc. ("Continental") operates (through its subsidiaries) the nation's third largest independent (non-Bell) telephone system, serving approximately two million customers in 37 states and the Caribbean.

Continental wishes to express its support for H.R. 1524 and its strong opposition to the enactment of H.R. 6503.

H.R. 1524 clarifies conflicting federal and state interpretations concerning a public utility's proper method of accounting, for ratemaking purposes, for the tax benefits of accelerated depreciation (cost recovery) and investment tax credit and eliminates massive federal tax deficiencies of certain California utilities resulting from past rate orders issued by the California Public Utilities Commission (CPUC). H.R. 1524 is identical to H.R. 6806 which was passed by the House during the last session of Congress.

Congress, in the Internal Revenue Code, required "nomalization" of the tax benefits of accelerated depreciation (cost recovery) and investment tax credit by public utilities so as to insure the benefits have their intended effect of providing an incentive for capital investment. The CPUC, responding to mandates issued by the California Supreme Court, has issued rate orders which establish an accounting method for the treatment of these tax benefits which has been held by the Internal Revenue Service to violate the Internal Revenue Code provisions by "flowing through" to ratepayers a portion of these tax benefits. Several California utilities face very substantial tax burdens because of these CPUC orders and will have enormous difficulty in financing these tax payments as well as the cost of facilities needed to furnish vital utility services. The utilities will have to challenge the Internal Revenue Service's position imposing the deficiencies by means of lengthy litigation.

Although this serious problem has first come about in California, other states regulatory commissions may adopt the CPUC's accounting methods which have been held to violate the Federal Internal Revenue Code provisions unless Congress acts to show that methods are *not* acceptable. If the states adopt such methods, Congress' intent in enacting the normalization requirement (to give the highly capital-intensive utility industry the same incentive to make capital investments as all other industries) will be undermined.

H.R. 1524 provides relief so that the methods adopted by the CPUC in the past will not retroactively result in the loss of taxt benefits to the affected utilities and also adds specific language to the Internal Revenue Code to make clear that the CPUC's methods do not satisfy the normalization requirements. H.R. 1524 also authorizes the Treasury Department to adopt regulations prescribing other accounting procedures and adjustments which would be inconsistent with the normalization requirements.

H.R. 6503, introduced by Congressman Stark, is identical to H.R. 3165 which he introduced during the last session of Congress and which was rejected by the Ways and Means Committee. This bill provides that a utility need not be permitted to earn a return on unamortized investment tax credit. This inability to earn on investment tax credit would deprive the highly capital intensive utility industry of the incentives to make capital investments which apply to other industries. If this legislation is enacted, virtually all benefits from investment tax credit presently available to the public utility industry would be eliminated.

The present normalization rules permit a utility to include the unamortized investment tax credit in the rate base resulting in a sharing of the credit's tax benefits between the utility and its ratepayers. H.R. 6503 would discontinue this sharing of the tax benefits so that the ratepayers would receive all the benefits. If a utility is not permitted to share in the credit's tax benefits, its revenues will decrease. This, in turn, will decrease the amount of federal income tax paid by a utility causing a decrease in revenue to the federal government.

Continental urges the Committee on Ways and Means to approve H.R. 1524 and to reject H.R. 6503 so that Congress' capital investment incentives will remain effective for the utility industry and to provide relief to the utilities effected by the accounting method required in the past by the CPUC.

STATEMENT OF THE NATIONAL ASSOCIATION OF WATER COMPANIES

This statement is submitted on behalf of the National Association of Water Companies. The National Association of Water Companies is an organization whose members primarily represent investor-owned public utilities which provide water service to millions of customers throughout the United States.

Of the two bills presently before the Committee, namely H.R. 1524 and H.R. 6503, our Association is primarily concerned with, and wishes to express its views on, section 1 of H.R. 6503. Section 1 of H.R. 6503 seeks to change the requirement to normalize the benefits of the investment tax credit. The proposed change significantly increases the flow-through of the benefits of these credits to the customer at the expense of the public utility. This is in direct opposition to the intent of Congress when the normalization requirements were adopted which were that the benefits of the investment tax credit should be shared between the customer and the public utility.

Section 46(f) of the Internal Revenue Code were presently provides that a pulic utility is considered to meet the normalization requirements by either reducing its rate base by the amount of the investment tax credit with a ratable restoration over the useful life of the asset, or by reducing its cost of service for rate-making purposes by no less than a ratable portion of the credit. This provision was designed by Congress to flow-through a portion of the benefit of the investment tax credit to the utility customer and allowing the public utility a share of such benefit is the form of improved cash flow.

Section 1 of H.R. 6503 would change this provision by requiring that the utility will be in compliance with the normalization rules only if it adheres to both the rate base reduction and the cost of service reduction rules above. This results in reduced cash flow to the public utility and ultimately in increased cost of capital. This certainly is not the time to place an added borrowing cost on any industry in our current economic climate.

CONCLUSION

The proposed change in the normalization rules distrub the sharing of benefits doctrine established by Congress when the original elections provided by Section 46(f) of the Internal Revenue Code were enacted. We believe that the proposed rule will result in less incentive to the utility to make needed capital investment and at that time increase the cost of investment capital to the utility. In short we do not believe that the proposed rule will result in a long range benefit to the utility customer and certainly is not in accord with the intent of the investment tax credit provisions. We therefore, vigorously oppose Section 1 of H.R. 6503.

STATEMENT OF THE SOUTHERN CALIFORNIA EDISON CO.

SUMMARY OF POSITION

Southern California Edison Company (SCE) strongly supports enactment of H.R. 1524, to amend sections 46(f) and 167(l) of the Internal Revenue Code of 1954 with respect to the treatment of public utility property. However, SCE is opposed to Section 1 of H.R. 6503, to amend the Internal Revenue Code of 1954 with respect to the limitations on the flow-through of the investment tax credit in the case of certain regulated companies.

SCE is an investor-owned public utility company which provides essential electric service to a population of more than 8,000,000 people in a 50,000 square mile area of central and southern California.

I. H.R. 1524

SCE believes that passage of H.R. 1524 is essential to enable public utility companies to compute their Federal income taxes using two important economic incentives to capital formation that Congress has previously provided—the accelerated cost recovery system (ACRS), and the investment tax credit (ITC). As a condition to claiming these incentives (as well as accelerated depreciation under prior tax law) Congress has required that utilities use certain ratemaking methods, referred to as "normalization", in determining their rates and in reporting operating results on their books. These methods are specified by Federal law and further explained in Treasury Regulations. Essentially, normalization means that utility rates reflect the benefit of tax reductions related to the depreciation expenses which are currently included in utility rates as a cost of service.

In various legislation since 1954, Congress has modified the provisions of the Internal Revenue Code to facilitate capital cost recovery, thereby improving cash flow and the financial health of American businesses. This on-going process to improve the financial health of American enterprise was manifest in the provisions of the Economic Recovery Tax Act of 1981 (ERTA) dealing with ACRS and ITC. The clear intent of the depreciation procedures adopted since 1954 has been to accelerate tax deductions thereby providing benefits to the taxpayer which would enable it to increase investment. However, as early as 1969, Congress recognized that the legislative goal of improving cash flow and financial health of utilities through accelerated depreciation and ITC was being circumvented by regulatory commissions which required utilities to reflect all of the tax benefits of accelerated depreciation and ITC in current rates through immediate flow-through accounting. The actions of these regulatory commissions (1) denied cash flow benefits to the utility taxpayer; (2) prevented tax benefits from accruing to future ratepayers; and (3) increased current revenue loss to the U.S. Treasury by reducing utility taxpayer revenues. Consequently, Congress has conditioned the availability of certain tax benefits, including ACRS and ITC, on the utility taxpayer using normalized accounting.

Although normalization of income taxes is the required accounting practice for non-regulated companies, and while the Federal Energy Regulatory Commission and the vast majority of state regulatory commissions have adopted normalization, and even though the Internal Revenue Code requires normalization for accelerated cost recovery benefits and investment tax credits, a few state regulatory commissions, most notably California, disagree with normalization.

The California Public Utilities Commission (CPUC) previously ordered two California-based telephone companies to account for accelerated depreciation and ITC using CPUC-imposed variations on the methods prescribed by Federal law and regulations. The CPUC asserted that the ratemaking methods which it ordered the telephone companies to use conformed to the requirements of Federal law. However, in private rulings the Internal Revenue Service (IRS) has determined otherwise, and these rulings could result in payments by the telephone companies of nearly two billion dollars in additional taxes. H.R. 1524 would alleviate these possible adverse consequences for the California telephone companies.

Importantly, however, H.R. 1524 has no adverse impact on the Federal revenues anticipated by Congress when it required normalization. Congress always intended that public utilities benefit, along with other industries, from these economic incentive provisions of the tax laws. It was never contemplated that these benefits would be lost to utility taxpayers due to technical differences between the IRS and state utility regulators on the interpretation of the law. Passage of H.R. 1524 will mean that Congress' original intention and policy will be implemented.

Furthermore, H.R. 1524 would clarify the normalization requirements related to accelerated cost recovery and ITC under ERTA and make it clear that the past CPUC method and similar methods are violative of those requirements and the intent of Congress.

The legislative history of both ERTA and H.R. 6806, the predecessor bill to H.R. 1524, which passed the House but failed in the Senate by one vote (in a unanimous consent procedure) in the last Congress, contains ample evidence of Congressional intent with respect to allowing utilities to benefit from accelerated depreciation and ITC through normalization of those benefits. Normalization improves the financial health of utilities, properly allocates tax benefits to ratepayers, and over the life of an asset results in customers paying less for utility service because of the utilities' improved financial condition. Prompt and favorable action on H.R. 1524 will emphasize the clear intent of Congress with respect to normalization in the strongest terms possible.

II. H.R. 6503

SCE strongly opposes the provisions contained in Section 1 of H.R. 6503 which would permit regulatory bodies to reduce both rate base and cost of service for ITC deferred under provisions of Internal Revenue Code Section 46(f). Under current law, public utilities must elect one or the other of such ratemaking treatments, but regulatory bodies are prohibited from requiring both. Allowing regulatory bodies to require both such reductions would remove much of the benefit of normalization which Congress has previously approved.

Adoption of these provisions of H.R. 6503 would result in substantial hardship to most public utilities which rely upon the internally generated funds provided by the present deferral options. Passage of this section of H.R. 6503 would mean that the capital formation benefits of existing tax law would be significantly diminished and utilities would be forced to borrow large sums of capital externally. This would

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occur at a time of high interest rates, high unemployment, a weak economy, and a continuing need by utilities with an already high level of borrowing for very large sums of money for use in their on-going construction programs. The increased capital burdens Section 1 would impose on utilities would also result in higher costs to utility customers—your constituents.

Additionally, Section 1 would result in reduced tax revenue to the U.S. Treasury. If tax benefits are immediately used to reduce utility rates, utility revenues and taxable income will be lower. As a result, tax payments by utilities will be further reduced.

The public utility industry strongly supported ERTA even though benefits to the industry were not as great as those afforded most other industries. Most public utility property received a recovery period considerably longer than the recovery periods applicable to other industries, resulting in lesser tax benefits. This inequity should not be exacerbated through further erosion such as that proposed by Section 1 of H.R. 6503. We urge your careful consideration of this further erosion and the effect it would have upon the financial health of the utility industry at this important time in our nation's economic recovery.

For the reasons set forth in this statement we urge the enactment of H.R. 1524 and the rejection of Section 1 of H.R. 6503.

STATEMENT OF UNITED TELECOMMUNICATIONS, INC.

United Telecommunications, Inc. ("United"), through its 26 telephone subsidiaries, operates the United Telephone System which comprises the nation's third-largest telephone group serving nearly five million telephones in 21 states. United confirms its support of H.R. 1524; however, United opposes H.R. 6503.

H.R. 6503 would take from public utilities virtually all the benefits of the investment tax credit, which under present law is structured to be shared by the public utilities and their customers. It would place utilities, telephone companies in particular, at a further disadvantage in competition with non-regulated providers of communciations services, as they would not be subject to these restrictive provisions. This bill adds confusion and uncertainty to utilities' ability to make long-range business plans and decisions, as it would terminate the election that these utilities made under the 1972 law in reliance upon their election being permanent. This bill effectively removes any incentive utilities might, otherwise have to make descretionary investments to enhance and expand their service facilities.

Conversely, H.R. 1524 accomplishes two worthwhile objectives. First, it provides needed guidance for regulatory bodies to incorporate the effect of deferred income tax from accelerated depreciation and the effect of investment credit into the ratemaking process in a manner consistent with the intent of Congress under Code sections 46(f), 167(1) and 168(3). Second, it removes a severe penalty from public utilities who have, through no fault of their own, been subjected to rate orders in the past which are inconsistent with the intent of these code sections.

Ratemaking is a complex process. H.R. 1524 gives a clear message to ratemaking bodies that the use of inconsistent estimates and projections is contrary to the original intent of Congress that there be a sharing of these benefits by the customers and stockholders of public utilities.

Absent H.R. 1524, it would appear to regulatory bodies that they have a duty to their ratepayers to follow the lead of the California authorities in setting rates in the manner which has been challenged by the Internal Revenue Service with certain California utilities. This could only lead to costly and time-consuming litigation in the courts, causing continued uncertainty and confusion among public utilities. In the end, both the utilities and their customers would suffer. H.R. 1524 eliminates this confusion immediately.

For those public utilities which have been the subject of inconsistent ratemaking orders in the past, H.R. 1524 removes the burden of additional tax, investment credit repayment and interest. These are dollars which Congress never intended to be paid at this time, the U.S. Treasury never anticipated to be received at this time, and which the utilities have done nothing to cause these tax deficiencies nor could they have taken any steps to prevent these deficiencies. If they are forced to pay these taxes at this time, they will have to borrow funds to do so. This will not only put an added burden on the capital funds market, but will also lower the utilities' credit ratings and further increase their cost of service through higher interest costs. Ultimately, it is the consumers who will have to pay these additional taxes and interest through higher utility rates—the same consumers which the regulatory body in its misguided efforts was attempting to benefit when it issued the rate

orders which proved contrary to the requirements of the Internal Revenue Code. H.R. 1524 removes these inequities by closing the door on past rate orders and allowing these companies to go forward on an equal footing with the public utilities in other states.

The concepts embodied in H.R. 1524 are based on sound accounting and ratemaking principles, By requiring a proper matching of costs and revenues, it insures that the ratepayers of today do not unduly benefit from current tax deferrals and investment credit at the expense of future ratepayers. In this period of deregulation of the telecommunications industry, it is critical to an orderly transition that rates be established based on a true reflection of current costs, including income taxes, rather than being artificially skewed by improper methods of income tax allocation. This legislation insures that the ratemaking treatment reflects the proper allocation of income tax deferrals and investment credits in the appropriate accounting periods.

United urges the Congress to pass this much-needed legislation embodied in H.R. 1524, thereby setting firm ground rules for the future and rescuing those utilities which did not have the protection of these rules in the past.

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97TH CONGRESS
1ST SESSION

H. R. 1524

To amend sections 46(f) and 167(l) of the Internal Revenue Code of 1954 with respect to the treatment of public utility property.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 30, 1981

Mr. ROUSSELOT (for himself and Mr. MATSUI) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend sections 46(f) and 167(l) of the Internal Revenue Code of 1954 with respect to the treatment of public utility property.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. NORMALIZATION METHOD FOR PURPOSES OF DEPRECIATION.

Paragraph (3) of section 167(l) of the Internal Revenue Code of 1954 (relating to definitions for purposes of depreciation in the case of utilities) is amended by redesignating subparagraphs (H) and (I) as subparagraphs (I) and (J), re

spectively, and by inserting after subparagraph (G) the following new subparagraph:

"(H) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC.—

"(i) IN GENERAL.—One way in which the requirements of subparagraph (G) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (G).

"(ii) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS.—The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (G)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

"(iii) REGULATORY AUTHORITY.—The Secretary may by regulations prescribe procedures and adjustments (in addition to those

specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i)."

SEC. 2. COMPUTATIONS FOR PURPOSES OF INVESTMENT CREDIT.

Subsection (f) of section 46 of such Code (relating to limitation in case of certain regulated companies) is amended by adding at the end thereof the following new paragraph:

"(10) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC., FOR PURPOSES OF PARAGRAPHS (1) AND (2).—

"(A) IN GENERAL.—One way in which the requirements of paragraph (1) or (2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of paragraph (1) or paragraph (2), as the case may be.

"(B) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS.—The procedures and adjustments which are to be treated as inconsistent for purposes of subparagraph (A) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's qualified investment for purposes of the credit allowable by section 38 unless such esti-

mate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

"(C) REGULATORY AUTHORITY.—The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in subparagraph (B)) which are to be treated as inconsistent for purposes of subparagraph (A)."

SEC. 3. EFFECTIVE DATES.

(a) GENERAL RULE.—The amendments made by sections 1 and 2 shall apply to taxable years beginning after December 31, 1979.

(b) SPECIAL RULE FOR PERIODS BEFORE MARCH 1, 1980.—

(1) IN GENERAL.—Notwithstanding the provisions of sections 167(l) and 46(f) of the Internal Revenue Code of 1954 and of any regulations prescribed by the Secretary of the Treasury (or his delegate) under such sections, the use for ratemaking purposes or for reflecting operating results in the taxpayer's regulated books of account, for any period before March 1, 1980, of—

(A) any estimates or projections relating to the amounts of the taxpayer's tax expense, depreciation expense, deferred tax reserve, credit al-

lowable under section 38 of such Code, or rate base, or

(B) any adjustments to the taxpayer's rate of return,

shall not be treated as inconsistent with the requirements of subparagraph (G) of such section 167(l)(3) nor inconsistent with the requirements of paragraph (1) or (2) of such section 46(f), where such estimates or projections, or such rate of return adjustments, were included in a qualified order.

(2) QUALIFIED ORDER DEFINED.—For purposes of paragraph (1), the term "qualified order" means an order—

(A) by a public utility commission which was entered before March 13, 1980,

(B) which used the estimates, projections, or rate of return adjustments referred to in paragraph (1) to determine the amount of the rates to be collected by the taxpayer or the amount of a refund with respect to rates previously collected, and

(C) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced).

(c) NO INFERENCE.—The application of subparagraph (G) of section 167(l)(3) of the Internal Revenue Code of 1954, and the application of paragraphs (1) and (2) of section 46(f) of such Code, to taxable years beginning before January 1, 1980, shall be determined without any inference drawn from the amendments made by sections 1 and 2 of this Act or from the rules contained in subsection (b) of this section. Nothing in the preceding sentence shall be construed to limit the relief provided by subsection (b).

(d) DELAY IN MAKING REFUNDS OR CREDITS.—No refund or credit of any overpayment of tax attributable to the amendments made by this Act shall be made or allowed before October 1, 1981.

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97TH CONGRESS
2D SESSION

H. R. 6503

To amend the Internal Revenue Code of 1954 with respect to the limitations on the flow-through of the investment tax credit in the case of certain regulated companies.

IN THE HOUSE OF REPRESENTATIVES

MAY 27, 1982

Mr. STARK introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the limitations on the flow-through of the investment tax credit in the case of certain regulated companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subparagraph (A) of section 46(f)(1) of the Internal Revenue Code of 1954 (relating to limitations in case of certain regulated companies) is amended to read as follows:

"(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable

by section 38 (determined without regard to this subsection); or".

(b) Paragraph (2) of section 46(f) of such Code is hereby repealed.

(c)(1) Paragraph (3) of such section 46(f) is amended by striking out "paragraphs (1) and (2)" and inserting in lieu thereof "paragraph (1)".

(2) Subparagraph (A) of paragraph (4) of such section 46(f) is amended—

(A) by striking out "paragraphs (1), (2), and (9)" and inserting in lieu thereof "paragraphs (1) and (9)", and

(B) by striking out "paragraph (1), (2), or (9)" each place it appears and inserting in lieu thereof "paragraph (1) or (9)".

(3) Subparagraph (B) of paragraph (4) of such section 46(f) is amended by striking out "without regard to this subsection)—" and all that follows and inserting in lieu thereof "without regard to this subsection) on the taxpayer's cost of service for ratemaking purposes or in its regulated books of account or rate base for ratemaking purposes."

(4) Paragraph (6) of such section 46(f) is amended by striking out "paragraph (2)(A)" and inserting in lieu thereof "paragraph (1)(A)".

(5) The third sentence of paragraph (8) of such section 46(f) is amended to read as follows: "If such taxpayer does not make such an election, paragraph (1) shall apply to such excess credit."

(d) The amendments made by this section shall apply with respect to qualified investment for taxable years beginning after the date of the enactment of this Act.

SEC. 2. (a) Notwithstanding the provisions of sections 167(l) and 46(f) of the Internal Revenue Code of 1954 and of any regulations prescribed by the Secretary of the Treasury (or his delegate) under such sections, the use for ratemaking purposes or for reflecting operating results in the taxpayer's regulated books of account, for any period before March 1, 1980, of—

(1) any estimates or projections relating to the amounts of the taxpayer's tax expense, depreciation expense, deferred tax reserve, credit allowable under section 38 of such Code, or rate base, or

(2) any adjustments to the taxpayer's rate of return,

shall not be treated as inconsistent with the requirements of subparagraph (G) of such section 167(l)(3) nor inconsistent with the requirements of paragraph (1) or (2) of such section 46(f), where such estimates or projections, or such rate of return adjustments, were included in a qualified order.

(b) For purposes of subsection (a), the term "qualified order" means an order—

(1) by a public utility commission which was entered before March 13, 1980,

(2) which used the estimates, projections, or rate of return adjustments referred to in subsection (a) to determine the amount of the rates to be collected by the taxpayer or the amount of a refund with respect to rates previously collected, and

(3) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced).

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